

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
LOWE’S HOME CENTERS, INC.	:	DETERMINATION
	:	DTA NO. 818411
for Redetermination of a Deficiency or for Refund of	:	
Corporation Franchise Tax under Article 9-A of the Tax	:	
Law for the Fiscal Years Ending January 31, 1997 and	:	
January 30, 1998.	:	

Petitioner, Lowe’s Home Centers, Inc., P.O. Box 1111, North Wilkesboro, North Carolina 28656, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ending January 31, 1997 and January 30, 1998.

A hearing was held before Gary R. Palmer, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York commencing on March 13, 2002 and continuing on March 14 and June 10 through June 14, 2002. The matter was thereafter continued at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York on August 14 and 15, and August 28 through 30, September 4 through 6, 11 and 12, 2002. The hearing concluded in Troy, New York on November 4 through November 7, 2002, with all briefs to be submitted December 31, 2003, which date began the six-month period for the issuance of this determination. The six-month period was extended for an additional three months pursuant to 20 NYCRR 3000.15(e)(1). Petitioner appeared by Phillips, Lytle, Hitchcock, Blaine & Huber, LLP (Edward M. Griffith, Jr., Esq. and Gary J. Gleba, Esq., of counsel), and by

Morrison & Foerster, LLP (Craig B. Fields, Esq., of counsel). The Division of Taxation appeared by Mark F. Volk, Esq. (Nicholas A. Behuniak, Esq. and Clifford M. Peterson, Esq., of counsel).

ISSUE

Whether the Division may require petitioner to file its franchise tax report on a combined basis with its sister corporation, LF Corporation.

FINDINGS OF FACT

1. Pursuant to section 3000.15(d)(6) of the Rules of Practice and Procedure of the Tax Appeals Tribunal and section 307(1) of the State Administrative Procedure Act, both parties submitted proposed findings of fact. Petitioner has submitted 126 proposed findings of fact, and the Division has submitted 360 proposed findings of fact. The proposed findings of fact have been substantially incorporated into this determination with the exception of those noted in the final two findings of fact.

2. Petitioner, Lowe's Home Centers, Inc. ("LHC"), a North Carolina corporation, is a retailer of home improvement products and a wholly-owned subsidiary of Lowe's Companies, Inc. ("LCI"), which is also a North Carolina corporation.

3. LF Corporation ("LF") is a Delaware corporation and a wholly-owned subsidiary of LCI. LF's office is located in Wilmington, Delaware. LF was incorporated in Delaware on July 6, 1989 for purposes that include the ownership of certain trade names and trademarks formerly owned by LCI. LF did not operate any home improvement stores, sell any products or operate any distribution centers during the tax years at issue.

4. As a result of a corporation franchise tax field audit, the Division of Taxation (“Division”) on December 26, 2000 issued a Notice of Deficiency to LHC asserting additional corporation franchise tax due in the sum of \$45,859.00 plus penalty and interest for the fiscal year ending January 31, 1997 (“tax year 1996”) and tax in the sum of \$300,553.00 plus penalty and interest for the fiscal year ending January 30, 1998 (“tax year 1997”).

5. LHC filed a timely petition with the Division of Tax Appeals challenging the imposition of the additional corporation franchise tax. Petitioner alleges that the Division erroneously required petitioner to file combined corporation franchise tax reports with LF for tax years 1996 and 1997.

6. During tax years 1996 and 1997 petitioner exclusively operated all Lowe’s retail stores except those located in North Carolina and Ohio. Petitioner also owned four regional distribution centers during this period. During this same time period petitioner was building and opening between 70 and 80 new stores each year. By late 1997 petitioner was operating all Lowe’s stores, which then numbered over 400. As of 2002, about 70 percent of the Lowe’s stores were owned by petitioner, with the remaining 30 percent being leased. Petitioner had about 50,000 employees during the tax years at issue.

7. For a portion of tax years 1996 and 1997 LCI operated the retail stores in North Carolina and Ohio. During tax year 1996 LCI transferred by merger the Ohio stores to petitioner, and during tax year 1997 it transferred the North Carolina stores to petitioner. LCI continued to serve as the centralized corporate management arm of the Lowe’s group and the provider of executive management services to LHC. For these services LHC paid to LCI an annual management fee. For tax year 1996 this management fee was \$24,963,568.00. For tax year 1997 this fee was \$31,022,870.00. LCI employed about 10,000 persons during this period.

LF had one employee during the tax years at issue. It did not pay any management fees to LCI during this period.

8. LCI and its subsidiaries were reorganized in 1989. Before the reorganization LCI had about 24 wholly-owned subsidiaries. Each subsidiary operated all the stores in a particular state under the style, Lowe's of Alabama, etc. Pursuant to the 1989 reorganization these subsidiaries, with the exception of those owning the stores in Ohio and North Carolina, were merged into Lowe's Investment Company ("LIC"), whose corporate name was later changed to Lowe's Home Centers, Inc. LIC, which became LHC, owned all the store real estate and was qualified to do business in each state where the retail stores were located.

9. Before the 1989 reorganization and the formation of LF, LCI owned the marks and permitted their use, including the trade name, Lowe's, by the various subsidiaries at all their retail locations. There were no written licensing agreements, no provision for the payment of royalties, no quality control standards and no formal monitoring of the use of the marks by either LCI or the various subsidiaries.

10. Gaither Keener, Esq., and Paul B. Bell, Esq., were intellectual property attorneys retained by LCI in the mid-1980s. Each testified on behalf of petitioner that abandonment could be asserted as a defense to a claim for the unauthorized use of the marks by third parties because of the failure of LCI to exercise quality control over the marks.

11. During the period from 1988 through 1990 LCI developed a vision statement for the Lowe's group in response to Home Depot's having overtaken Lowe's as the largest home improvement retailer in the country. The thrust of the vision statement was that Lowe's must become more centralized on all levels so as to be perceived as one organization rather than a group of different stores acting independently of one another.

12. At the time LF was incorporated in 1989 petitioner had no stores in New York State and had no plans to establish stores in the State. Petitioner opened its first store in New York State, on October 24, 1996, in Vestal. Petitioner opened four additional stores in New York State in the latter part of 1997. These stores were located in Utica, Big Flats, Kingston and Auburn.

13. In January 1989 Arthur Andersen, LLP (“AA”) completed a state tax study to determine how best to restructure the intercorporate relationship of LCI and its subsidiaries to identify tax minimization opportunities, particularly how to take advantage of state net operating loss carryovers. In its study AA “strongly” recommended the creation of a separate finance and trademark company in a “tax haven state” for the purpose of producing substantial state tax savings. The study identified Delaware, Nevada, New York and Texas as tax haven states, but focused on Delaware as the state first considered by businesses that utilize the affiliated finance company concept because, by statute, Delaware specifically provides that corporations whose activities within the state are confined to the maintenance and management of their intangible investments and the collection and distribution of income from such investments are exempt from income taxation. The purpose of the investment holding company was to acquire and hold LCI’s intangible assets including the Lowe’s trade names, trademarks and service marks. Under the proposal the Delaware holding company owning the marks would then license the use of the trade name and trademarks to the various store locations in return for an arm’s-length royalty. As long as the holding company confined its operations to Delaware, it would not be taxed on its receipt of the royalties and the operating affiliates paying the royalties would be entitled to a deduction for state and local tax purposes.

14. The AA study noted the existence of certain risks to the success of the proposed tax saving measures, including a finding by a state agency that the royalty payments are not arm's length and the requirement by the state that the holding company's income be combined with that of the local affiliate for reporting purposes.

15. The proposed transfer of the trade names, trademarks and service marks owned by LCI to a Delaware financial subsidiary and license-back arrangement underlying the AA study was reviewed by Mr. Bell, at the request of LCI's general counsel, to determine whether the proposed transfer might jeopardize the Lowe's trade name and trademark rights. In his testimony Mr. Bell addressed areas of the Lowe's operation, as it existed in 1989, that he felt needed attention. He expressed concern with the fact that the individual stores were operating on their own with little, if any, oversight from the parent company. In his 1989 letter to LCI's general counsel, Mr. Bell stated that the public policy purpose of the law of trademarks and unfair competition was to protect the public from confusion and deception relating to the origin of products and services, and to avoid the abandonment of a registered trademark through the separation of the mark from its associated goodwill. Mr. Bell concluded that because the transfer was to be between corporations in the parent/subsidiary relationship with common officers and directors, and because the element of control was present together with a sound business purpose, these factors would serve to prevent any diminution of trademark or trade name rights. According to Mr. Bell, a further advantage of the proposed transfer of Lowe's marks to a corporation that did not carry the Lowe's name was to render it less likely that an infringer in search of a defense, such as abandonment of a mark, would look behind the new corporate owner to discover a deficiency in quality control standards maintained for the marks by their former owner.

16. On June 9, 1989 the board of directors of LCI adopted a resolution approving the formation of LF, which was incorporated in Delaware on July 6, 1989 as an investment and trademark holding corporation exempt from state income taxation under Delaware Code § 1902(b)(8). The resolution did not specify any preexisting problems with the manner in which LCI or LHC used or controlled the marks. The specific corporate purpose, as stated in the LF certificate of incorporation, was to maintain and manage its intangible investments and the collection and distribution of the related income.

17. By subscription agreement dated August 1, 1989, LCI acquired rights to 582 shares of LF's common stock to be issued on August 31, 1989 in exchange for the transfer by it to LF of all its right, title and interest in and to certain trademarks together with the associated goodwill of its business symbolized by the trademarks, along with applicable trademark registrations and applications therefore. Also assigned to LF in return for the shares of common stock was a promissory note to be dated September 1, 1989, evidencing an obligation of petitioner to LCI in the sum of \$313,952,171.81. The assignment of the marks and the United States trademark/service mark registrations and applications to LF was recorded with the United States Patent and Trademark Office on or about September 1, 1989.

18. By separate license agreements, both dated August 31, 1989, LF, as "licensor," outlined the terms and conditions whereby it granted a nonexclusive, nontransferable personal right and license to the use of the name "Lowe's" and all other trade names, trademarks and service marks owned by LF to LCI and LHC as "licensees." Under the terms of the license agreements the licensor assumed the responsibility to maintain the licensed marks in full force and effect by filing renewals and such other documents as may be required by law to keep the marks in active status.

19. The license agreements of August 31, 1989, by their terms, provided that a reasonable and fair royalty for the use of the licensed marks is 3.4 percent of the gross sales by the licensees at each of their retail establishments. The license agreements further imposed upon the licensees the obligation, as the representatives of the licensor, to preserve the high standards and goodwill of the licensed marks and to exercise such supervision and control with respect to all of their retail merchandising establishments as to preserve and enhance the goodwill of the marks. The licensor reserved the right to inspect all retail facilities, review licensed services and approve samples of licensed products as well as advertising and promotional materials using the licensed marks.

20. By amendment number 1 to each of the license agreements dated August 31, 1989, LF and LHC in the one instance, and LF and LCI in the other instance, agreed that effective September 1, 1991 the royalty rate would be reduced to 2.5 percent of gross sales.

21. LCI and LF entered into an amended and restated license agreement effective January 31, 1998 covering the period immediately following the fiscal years at issue, which agreement provided that the "license granted hereunder shall be non-royalty bearing."

22. LF leased an office in Wilmington, Delaware for the fiscal years ending January 31, 1997 and January 30, 1998 under a one-year renewable lease providing for annual rent in the sums of \$10,325.00 and \$10,413.00, respectively. The office consisted of four rooms plus kitchen and bath and was not shared with any other entities.

23. In 1989 LCI retained Valuation Engineering Associates, an affiliate of Touche Ross, to conduct an appraisal of the Lowe's trade name. Its report, dated August 17, 1989, noted that intangible assets exist at all phases of the business operation, generally produce value in excess of their costs, and enhance the value of the firm by either increasing revenue or reducing costs.

Using the cost approach, it was determined that the fair market value of the Lowe's trade name as of June 30, 1989 was \$266,500,000.00, and the recommended pretax royalty rate was 3.4 percent of sales. The cost approach determines the value of a trade name or trademark as the cost required to recreate the current level of brand loyalty, consumer awareness or product recognition enjoyed by the firm. A determination was also made in the underlying report that the remaining economic life of the Lowe's trade name was five years.

24. In 1991 AA was retained by LF to estimate the fair royalty rate value of the trademarks and trade names. For the purpose of its valuation, AA defined the term "fair royalty rate" as the "royalty rate at which the property under consideration would be licensed in an arm's-length transaction between a willing licensee and a willing licensor, each informed but neither under any compulsion to act." AA determined that effective July 31, 1991 the fair royalty rate value was 2.5 percent of net sales which was based on historical operating margins, the industry's cost of capital, and royalty rates paid by what it claimed were comparable companies engaged in the same or similar lines of business. The cost of capital was used to estimate the appropriate discount rate to apply to the various royalty rates paid by the companies analyzed. This discount rate was based on the weighted average cost of capital of petitioner and the industry. The factors considered in determining the royalty rate included profitability, market recognition, market share, barriers to entry, product loyalty and business risk. AA's research revealed that the rates charged for licensing what it claimed were comparable products in comparable industries ranged from .5 percent to 2.5 percent of net sales. The work papers in support of the 1991 AA report do not indicate why the Lowe's trademark belonged at the high end of this range, nor do they identify the actual companies claimed to be comparable to Lowe's or the products or services licensed. The arithmetic mean of the royalty rates listed in the

summary table to the 1991 AA analysis (Exh S-1) was 2 percent, but listed as 2.1 percent. The 2.5 percent concluded royalty rate exceeded that mean. The 2.5 percent royalty rate paid by petitioner to LF during tax years 1996 and 1997 was based, in part, on the 1991 AA report.

25. In 1997 AA was again engaged to estimate the fair market royalty rate to be charged for the use of the Lowe's trade name and that of another LCI subsidiary, The Contractor Yard, Inc., which was formed in 1994 to serve the professional contractor market. Because of the emergence in the 1990s of Home Depot and Lowe's as the dominant "big box" home centers, which in February of 1997 had a combined market share of 15 percent, small independent and regional chain home centers were forced to merge or go out of business. Home Depot had home centers in the United States and Canada during the years at issue. Among the factors considered by AA in its 1997 analysis to determine an arm's length royalty rate were Lowe's name recognition, market share, and barriers to entry. AA attempted to apply the "best method rule" of Treasury Regulation § 1.482-1(c) whereby it determined that the best method to use to estimate the arm's-length royalty rate to be paid by petitioner for its use of the Lowe's trade name was the comparable uncontrolled transaction ("CUT") method of Treasury Regulation § 1.482-4(c). Under the CUT methodology the appraiser had to identify comparable uncontrolled companies in the retail home improvement industry. AA selected six purported comparable companies for use in its analysis. The six companies were Home Depot; BMC West Corporation; Wolohan Lumber; DIY Home Warehouse, Inc.; Wickes Lumber Company and Eagle Hardware & Garden, Inc. AA examined the profit margins of the six companies and determined that the average profit margin of the six companies for the latest fiscal year was 6 percent while Lowe's profit margin for the same period was 8.1 percent, ranking Lowe's in second place behind Home Depot. AA observed that the fact that Lowe's profit margin was

higher than all but one of the six companies supported the use of a higher than the average royalty rate for the Lowe's trade name. AA eliminated Home Depot and Wickes Lumber Company as comparable companies to petitioner in its 1997 study. Home Depot was eliminated because it owned valuable intangible assets and Wickes was eliminated because it had significant manufacturing operations. In applying the CUT method AA determined that the royalty rate range of the remaining four companies was from 1 percent to 5 percent, and that based on Lowe's comparative size, market position, profitability and registered trademark status, it concluded that a 3 percent of sales royalty rate was appropriate for the Lowe's trade name. There was no showing by AA that the intangible assets owned by the four uncontrolled companies had a similar profit potential to that of petitioner's intangible assets. The 1997 AA report attributed a large part of the residual intangible asset value to the trademarks and trade names, as opposed to petitioner's other intangible assets.

26. During the years at issue Homer TLC, Inc. ("Homer"), a wholly-owned indirect subsidiary of Home Depot, owned certain trademarks, including the name "The Home Depot." Homer licensed the use of these trademarks to Home Depot's operating subsidiaries.

27. In 2000 AA was engaged to again examine the royalty rate paid by LHC to LF for the intercompany licensing of the marks. The transfer pricing report it issued, dated March 2, 2000, was not prepared in anticipation of litigation and did not focus specifically on the tax years at issue. In applying the CUT method, AA identified what it considered to be two comparable uncontrolled transactions with license agreements that involved the transfer of similar intangible property under circumstances it considered to be substantially the same as the LHC-LF controlled transaction. The requirement of the CUT method that the profit potential of the intangible property involved in the uncontrolled transaction be similar to the profit potential of

the intangible property involved in the controlled transaction was not complied with by AA as required by section 1.482-4(c)(2)(iii)(B)(1)(ii) of the Treasury Regulations. The first such license agreement licensed the use of the Century 21 trade name and trademark from Century 21 Real Estate Corporation (“Century 21”) to American Remodeling, Inc. (“AMRE”). This agreement, dated October 7, 1995, entitled AMRE to use the Century 21 trade name and logo in its sale of home improvement products and services in return for a royalty payable to Century 21 of three percent of net sales plus an additional annual payment of \$10 million to the Century 21 National Advertising Fund to promote the Century 21 trade name and the products sold by AMRE under that name.

28. The second purported comparable agreement was a franchise agreement for the franchise of Ace Hardware Stores marks providing for a royalty of 2 percent of net sales plus an advertising fee of 1.3 percent of net sales, for a total of 3.3 percent. Because retail franchise agreements provide franchisees with intangible property related to the operation of the franchised stores in addition to the use of trade names and trademarks, AA determined that the Century 21-AMRE agreement was a more reliable comparable uncontrolled transaction which supported an arm’s-length royalty rate of three percent of net sales.

29. A comparable profits method (“CPM”) analysis was employed in 2000 by AA to confirm its findings under the CUT method that three percent of net sales was an arm’s-length royalty rate. This method compares the profitability of the tested party, which was Lowe’s consolidated companies, as measured by a profit level indicator, to the profitability of uncontrolled taxpayers in similar circumstances. In this analysis AA obtained income statement and balance sheet data from six uncontrolled home improvement retailers, five of whom it considered to be comparable to LHC. After excluding Home Depot from this group of six, AA

proceeded to calculate separate operating margins for 1996, 1997 and 1998 for each of the remaining five entities, who are: Building Materials Holding Corp.; DIY Home Warehouse, Inc.; Homebase, Inc.; White Cap Industries, Inc.; and Wolohan Lumber Co. The highest and the lowest operating margin in the range of operating margins for each of the three years was excluded to create an interquartile range. This interquartile range of operating margins was compared to the operating margin earned by Lowe's consolidated companies in each of the fiscal years ending January 1997, 1998 and 1999. These operating margins in the 2000 CPM study were obtained from financial information derived from the Lowe's consolidated companies, including LCI, LHC, LF and other subsidiaries of LCI. The direct source of this information was a Compustat electronic financial database.

30. During the years at issue LF had one employee, Gisela Eubanks, who, at the time of her testimony, held the titles of assistant secretary and comptroller of LF. She has worked for LF since June 1995. Ms. Eubanks is a certified public accountant who worked on both trademark and investment matters. Ms. Eubanks conducted LF's day-to-day operations, including the payment of expenses, collection of revenues, maintenance of books and records, issuance of her own payroll checks, and the maintenance of checking and investment accounts. In addition, Ms. Eubanks worked with Wilmington Trust Company representatives relating to investments, outside accountants relating to financial statements and preparation of state tax returns, the LCI internal audit group relating to quality control audits, and outside legal counsel relating to general legal matters. Ms. Eubanks attended LF board of directors meetings at which she would report on financial matters and take minutes. Her corporate check signing authority was limited to \$2,000.00. Prior to Ms. Eubank's employment with LF in 1995, her duties were performed by Delaware Corporate Management, Inc., which provided office space, part-time clerical support, accounting and related services.

31. During the tax years at issue LF had an investment management agreement and a custodial agreement with Wilmington Trust Company. Wilmington Trust invested funds on behalf of LF pursuant to investment guidelines established by LF's board of directors. A Wilmington Trust representative reported investment portfolio performance orally and in writing to LF's board of directors at its quarterly meetings. The investment portfolio was worth about \$50 million during the tax years at issue. In recent years LF's investments have produced a higher rate of return than the short-term investment portfolio maintained by LCI.

32. During the tax years at issue Alston & Bird handled all trademark matters for LF and LCI, including filing registrations for and renewing trademarks, filing registrations and renewals of internet domain names, monitoring third-party trademark applications for possible infringement issues and addressing such issues as they arose, maintaining a database of LF's marks and overseeing foreign trademark registrations. A Wilmington, Delaware law firm, Stewart & Associates, handled LF's general legal matters including reviewing leases, loan agreements and license agreements.

33. On August 31, 1993 the Internal Audit Department of LCI was engaged by LF Corporation to perform quality control audits of Lowe's retail facilities in accordance with the Standards of Quality for Licensees promulgated by LF Corporation. These store audits were conducted during the fiscal years under review with the results compiled in an annual report to the LF board of directors. The Standards of Quality for Licensees required the review of such matters as the cleanliness and appearance of the stores, parking lots and the landscaping; the appearance and state of repair of vehicles; the uniformity and quality of forms, letterheads and packaging bearing the licensed marks; and the appearance, attitude and training of employees. The Internal Audit Department may perform a full store audit, which takes two employees two

weeks to complete, or a mini-audit, which can be completed by one employee in a day and a half. In tax year 1996, the Internal Audit Department completed 89 full store audits and 344 mini-audits. LF paid LCI's internal audit group for its services based on an hourly rate established at the beginning of each fiscal year, which rate included direct personnel costs as well as administrative and overhead costs. LF's share of the total cost of each audit was based on 10 man-hours for a full store audit and one man-hour for a mini-audit. For tax year 1996, LF paid to LCI \$33,850.00 for the services of its Internal Audit Department. For tax year 1997 LF paid \$42,150.00 for these services. The Internal Audit Department reported the results of its audits to LF on an annual basis, unless a store was deficient in meeting its quality control standards. In such cases, LF was notified immediately. When LCI notified LF that a store was in violation of the Standards of Quality for Licensees, LF sent a letter to LCI's chief operating officer notifying him of the violation. The record does not indicate any follow-up on the part of LF after it sent the letter to LCI regarding a violation.

34. During the tax years at issue LF paid fees for membership in the Geoffrey Coalition, a group formed by Price Waterhouse to monitor state tax developments on behalf of its members.

35. During the tax years at issue LF filed state tax returns and paid taxes to several states, including North Carolina and South Carolina. It also reimbursed LCI for its share of the consolidated Federal tax liability.

36. During the tax years at issue LF borrowed funds under an arrangement with a Citibank subsidiary ("CAFCO"). Under this arrangement LHC and LCI assigned a security interest in their receivables to LF which, in turn, assigned the security interests to CAFCO. CAFCO then sold commercial paper secured by the receivables. The funds generated by these sales were loaned by CAFCO to LF. Upon its receipt of the funds, LF transferred the funds to

LCI at the same interest rate plus a spread of 7½ basis points (.075%). LCI in turn loaned these funds to LHC for capital expansion. LHC made payments of interest only to LF with no payments of principal. LHC's interest payments were claimed as a deduction on its state tax returns. In tax year 1996 LHC made interest payments to LF in the sum of \$113,848,561.00 and in tax year 1997 LHC's interest payments to LF totaled \$115,965,787.00. LF paid no state tax on its interest income from LHC. Any out-of-pocket expenses incurred by LF in connection with the arrangement were reimbursed by LCI. Ms. Eubanks determined the maturity of the commercial paper sold by CAFCO.

37. During the tax years at issue LF's board of directors held quarterly meetings at the law offices of Stewart & Associates in Wilmington, Delaware. Before each meeting an agenda was provided to the directors together with copies of reports and other documents that were to be discussed at the meeting. LF also held annual shareholder's meetings in Delaware. All of LF's issued shares were owned by LCI.

38. Among the matters discussed at the LF board meetings during the tax years at issue were trademark matters including new trademarks to be accepted by the board, foreign trademark registrations, and third-party requests to use LF's trademarks. Other matters discussed at the board meetings included LF's quarterly financial statements and the status of state tax audits. Investment matters discussed at the LF board meetings included the performance of its investment portfolio, changes to the investment guidelines and the current status of the CAFCO arrangement. The LCI vice-president in charge of the Internal Audit Department made an annual presentation to the LF board regarding the number of store audits and an overview of their results.

39. New trademarks and service marks are developed by the LCI marketing team. If requested, an investigation is then conducted by the patent and trademark attorneys to determine if the proposed new mark is registerable, i.e., whether or not it infringes the rights of third parties. If the mark is viable, then the attorneys may be asked to file an application for registration with the United States Patent and Trademark Office. There are no instances in LF's board minutes where the LF board directed that the attorneys be asked to file such applications.

40. Since 1989 the Lowe's store base has been transformed from a chain of small hardware and building materials stores into a chain of home improvement warehouse superstores. During tax year 1996 Lowe's large stores, defined as those with more than 80,000 square feet, generated 61 percent of total sales, while during tax year 1997, such stores generated 70 percent of total sales. By the end of tax year 1997 Lowe's had more than 446 stores located in 25 states. Between May of 1996 and May of 1997 sales rose by 26 percent. The shift to newer and larger stores permits a broader merchandise mix which translates into higher profit margins. In 1997, 86 percent of Lowe's total retail square footage was new since 1991 and 75 percent of its retail square footage was less than 4 years old. The broad product mix found in Lowe's stores and the well trained, knowledgeable employees who work there are key to Lowe's continued growth in sales.

41. Historically Lowe's had emphasized the needs of professional contractors in its retail operations. Beginning in 1989 that emphasis began to change whereby during the tax years at issue Lowe's focus was on the needs of the do-it-yourself homeowner.

42. Professor Richard D. Pomp testified on petitioner's behalf and his written report was received into evidence. Professor Pomp is a professor of law at the University of Connecticut

School of Law and an adjunct professor at both the New York University School of Law and Columbia Law School. He is the author, with Oliver Oldman, of a casebook, *State and Local Taxation*, that is used by law schools, accounting firms and corporations. He was the director of the New York State Tax Study Commission from 1982 to 1987. Professor Pomp has been retained as a consultant by the U.S. Department of Justice, U.S. Treasury Department, the Internal Revenue Service, the Multistate Tax Commission and various states including New York, New Jersey, Connecticut, Delaware and California. He was accepted and testified as an expert on Federal and state tax policy.

43. Before rendering his report and giving testimony, Professor Pomp reviewed certain documents along with transcripts of previous testimony. In addition, he conferred with certain LCI and LF directors, officers and employees as well as trademark counsel.

44. In his testimony Professor Pomp discussed the business purposes for which LF was formed in support of his position that it was not a shell corporation. He expressed his opinion that LF's business is a service business and that many service businesses, like LF, have high income and low expenses, and further, that the only policy significance to the commissioning by LF of four transfer pricing studies was to show that LF was trying to do the right thing.

45. Steve L. Snyder, a senior manager in the transfer pricing group of Deloitte Touche, was qualified and accepted by consent as an expert in transfer pricing. Mr. Snyder had been employed by AA from November 1999 to May 2002, and before that for 4½ years with Ernst & Young. He is a graduate of Vanderbilt University where he received an MBA. Of the approximately 150 transfer pricing studies Mr. Snyder had performed, 30 to 40 involved intangible assets and approximately two-thirds of that number involved state, as opposed to

Federal, tax matters. His experience includes eight studies involving the licensing of intangible assets in the retail industry. Mr. Snyder, with other AA employees, performed the analyses for the 2000 and 2002 AA studies to determine the arm's length range of the royalty rates to be paid by the LHC to LF. During the period when the 2000 AA transfer pricing study was being prepared, Mr. Snyder received an e-mail dated March 3, 2000 from a co-worker, Mr. Fijol, seeking direction in the preparation of the study. Mr. Fijol noted, with regard to the licensing company (LF), that the "functional analysis is thin" and "the licensing company doesn't currently have many functions to discuss."

46. Mr. Snyder described the methodologies he used and the conclusions he reached in both of the AA March 2, 2000 transfer pricing studies, as well as the two January 2002 studies he conducted. A CUT method and a CPM study was performed by Mr. Snyder for each year. AA had previously performed royalty rate studies on behalf of LF dated October 2, 1991 and November 14, 1997. Mr. Snyder reviewed the 1991 and the 1997 studies in his testimony, and discussed the details of the 2000 study that he authored. His information source for the 2000 CPM was financial information derived from the Lowe's consolidated companies filings that Mr. Snyder obtained from a Compustat electronic financial database. He prepared the 2002 transfer pricing CUT and CPM studies as supplements to his 2000 studies, and therefore omitted from the 2002 CUT and CPM the best method analysis he performed in conjunction with the 2000 studies.

47. In preparing for his 2002 transfer pricing studies, Mr. Snyder examined unaudited segmented income statements and balance sheets pertaining to LHC. He also examined annual

reports and Security Exchange Commission Forms 10-K for other companies in the home improvement industry.

48. In his 2002 CUT analysis, Mr. Snyder initially tried to identify internal comparable transactions involving either the licensing of LF's marks to an unrelated party in an industry similar to that of LHC, or to determine if LHC licensed similar marks from an unrelated party. He found what at first appeared to be a CUT involving a licensing agreement between an advertising affiliate of LHC and LF and an entity named Sports Marketing Enterprises which licensed the use of LF's marks in connection with the marketing of NASCAR racing apparel and souvenirs. Mr. Snyder rejected this licensing agreement because the sale of apparel and souvenirs represented a different profit potential than the sale of home improvement products.

49. Mr. Snyder next conducted a search of the Compact Disclosure database and the RoyaltySource Intellectual Property database in an effort to find licensing agreements between home improvement retailers and third parties comparable to the licensing agreement between LF and LHC. This search identified two potential comparable agreements that he determined to be CUTs. The first such agreement was between Century 21 and AMRE and the second agreement involved Sears, Roebuck and Company and AMRE. In 2002 Mr. Snyder rejected as a CUT the same Ace Hardware franchise agreement that he had relied on as a CUT in the AA 2000 transfer pricing study.

50. Under the Century 21-AMRE agreement AMRE was granted the use of the Century 21 home improvement trademarks within the United States in the marketing, selling and installation of home improvement products. The agreement provided that AMRE would pay to Century 21 a royalty equal to the greater of earned royalties or minimum royalties where earned

royalties were equal to three percent of AMRE contract revenue, and minimum royalties ranged from \$11 million in 1996 to \$27.9 million in 2005. In addition to the royalty payments, AMRE was required to pay \$10 million annually to the Century 21 National Advertising Fund. In 1996 AMRE paid the minimum royalty in the sum of \$11 million plus the \$10 million to the advertising fund. Petitioner maintains that by excluding the advertising expense as an adjustment and considering only the \$11 million royalty payment, the royalty amounted to 4.4 percent of net sales.

51. Under the Sears/AMRE agreement, AMRE was granted the right to use the Sears trade name in connection with its sales and installation of certain home improvement products. For this privilege AMRE was obligated to pay Sears a royalty equal to 12 percent of gross revenues until it paid \$320 million, then 9.5 percent until it paid \$335 million and 8 percent thereafter. In addition the agreement required AMRE to actively advertise and promote the products it sold and installed under the agreement. Mr. Snyder made a sales volume adjustment to account for LHC's higher level of sales compared to those of AMRE, which he determined resulted in a royalty rate of 8 percent of net sales. This 8 percent rate included the provision to AMRE by Sears of certain unspecified support services.

52. It is Mr. Snyder's position that the royalty rates agreed to in the Century 21-AMRE and the Sears Roebuck-AMRE licensing agreements support his contention that the 2.5 percent royalty rate used by LHC and LF in their licensing agreement is arm's-length. As with the CUT method employed in the AA 2000 transfer pricing study, there was in the 2002 study a failure to comply with the Treasury Regulation requirement that the intangible property involved in the controlled transaction be comparable to the intangible property involved in the uncontrolled transaction by demonstrating that both sets of intangibles have similar profit potential through

the direct calculation of the net present value of the benefits to be realized through the use of the intangible property.

53. In order to confirm the results of its 2000 and 2002 CUT analyses, AA conducted two CPM analyses, one in the year 2000 with the Lowe's consolidated companies as the tested party, and the second in 2002 with LHC as the tested party. In its 2000 CPM study, it sought to identify comparable retailers by searching 15 Standard Industrial Classification ("SIC") Codes in three electronic databases, which resulted in a pool of 176 companies. Following a review of short business descriptions of each company, AA eliminated 116 companies for various stated reasons, leaving 60 companies for a detailed examination of their Forms 10-K. Upon completing this review, AA selected five companies whose functions and risks it considered to be comparable to the Lowe's consolidated companies. The five companies were Building Materials Holding Corp.; Do-it-Yourself Home Warehouse, Inc.; Homebase, Inc.; White Cap Industries, Inc.; and Wolohan Lumber Co. Fiscal year 1996 through 1998 income statement and balance sheet information for the five companies was used to compute what Mr. Snyder found to be an arm's-length range of operating profit margins, which range was then adjusted to the working capital levels of Lowe's operating companies. This range of working capital adjusted operating margins was compared to the actual operating margins earned by the Lowe's consolidated companies after payment of the royalty to LF, and used to determine, according to Mr. Snyder, a range of arm's-length royalty rates to be paid to LF.

54. In the AA January 2002 CPM transfer pricing report, Mr. Snyder explained that he selected the CPM due to the availability and reliability of data from unrelated companies performing functions, bearing risks and owning routine intangible assets similar to those of LHC. He explained that he selected the operating profit margin as the profit level indicator

(“PLI”) because this PLI is often used where the tested party engages in the sale of products to end-users. Mr. Snyder omitted a best method analysis in this CPM study. Mr. Snyder conducted three searches to identify uncontrolled retailers that performed functions, faced risks and owned routine intangible assets similar to those of LHC. The three searches covered published data for the years 1990, 1995 and 1999, respectively.

55. In his search of the 1990 data, Mr. Snyder searched a total of 155 companies in 15 SIC codes to identify potential comparable companies. This group was reduced to 26 companies through his application of certain rejection criteria, which excluded companies that engaged in substantial design and development activities, companies that operated in an industry other than home improvement retailing and those having substantial operations outside the United States. Mr. Snyder then examined the annual reports and Forms 10-K of these 26 companies, resulting in the identification of five companies whose functions, risks and routine intangible assets he considered to be comparable to those of LHC.

56. The search of the 1995 data made use of the Compact Disclosure electronic database and the same primary SIC codes used in the 1990 search. Of the 172 companies identified by Mr. Snyder for further evaluation, 148 were eliminated through the application of the same rejection criteria used in the 1990 search. A detailed examination of the annual reports and Forms 10-K of the remaining 24 companies brought about the elimination of 16 companies, leaving 8 companies he identified as performing functions, assuming risks and owning routine intangible assets similar to LHC.

57. The third search, that of the 1999 data, proceeded in a similar vein wherein eight companies were ultimately identified by Mr. Snyder as performing functions, assuming risks and owning routine intangible assets comparable to LHC. After eliminating the duplicates between

the three searches, along with companies in financial distress and one company with incomplete financial data, Mr. Snyder was left with 11 companies which he subjected to financial analysis. The 11 companies were Building Materials Holding Corp. (“Building Materials”); DIY Home Warehouse, Inc. (“DIY”); Eagle Hardware and Garden, Inc. (“Eagle”); Hechinger Co. (“Hechinger”); Homebase, Inc. (“Homebase”); National Home Centers, Inc. (“National”); Orchard Supply Hardware Corp. (“Orchard”); Payless Cashways, Inc. (“Payless”); Strober Organization, Inc. (“Strober”); White Cap Industries, Inc. (“White Cap”); and Wolohan Lumber Co. (“Wolohan”).

58. Building Materials sold retail building materials primarily to professional contractors as well as to project oriented consumers. As of December 31, 1997 it operated 55 building materials centers in the western United States. Most of its stores feature value-added operations, which include the fabrication of roof trusses, pre-hung doors and pre-assembled windows. Its sales for the year ending December 1997 were \$728 million.

59. DIY operated 16 warehouse format home improvement centers that sell primarily to do-it-yourself customers. Its stores are located in northeast Ohio with each store in the size range of 66,000 to 109,000 square feet. Most of its stores are leased. DIY offers a high level of customer service. DIY’s sales for the fiscal year ending January 3, 1998 were \$210 million.

60. Eagle operated 30 home improvement warehouse style stores in the western United States primarily serving do-it-yourself customers as well as professional contractors. Its stores averaged 125,000 square feet, about half of which are leased. It maintained one 214,000 square foot distribution center which handled about 20 percent of its merchandise. Eagle’s sales for the fiscal year ended January 30, 1998 were \$971 million.

61. Hechinger sells products for home and garden at retail primarily to do-it-yourselfers. Through subsidiaries it operated 64 stores under the Hechinger name, 52 stores using the name “Home Quarters Warehouse” and one store in Albany, New York under the name “Better Spaces.” All but 22 stores were leased. These stores are located in the eastern and central states and average 70,000 square feet. Its sales for the 34-week period ending September 27, 1997 were \$1.36 billion, and for the 53-week period ending October 3, 1998 its sales totaled \$3.44 billion. Hechinger posted net losses throughout the period from January 1995 to October 1998.

62. Homebase is the second largest operator of home improvement warehouse stores in the western United States selling at retail to do-it-yourself and professional contractor customers. In January 1999 it operated 84 stores in 10 states averaging about 103,000 square feet in size. All but 19 of its stores were leased. Its sales for the fiscal year ending January 31, 1998 were \$1.5 billion.

63. National operated nine home center stores in Arkansas selling to do-it-yourself and professional contractor customers. Of the nine stores, five were leased. The stores average 125,000 square feet in size. It operates value-added production facilities wherein it manufactures countertops, pre-hung doors and window units. National’s sales for the fiscal year ending January 31, 1998 were \$151 million. It posted losses during its fiscal years ending January 1997 and January 1998.

64. Orchard operated 60 hardware stores in northern and central California catering to the “fix-it” homeowner, filling the niche between small hardware stores and large home improvement warehouses. Forty-nine of its stores are leased. Its stores averaged around 40,000 square feet in size. Orchard’s most recent sales figures in the record are taken from its Form 10-

Q for the quarter ending July 28, 1996, where sales for the six-month period ending July 28, 1996 were \$303 million.

65. Payless operated 164 retail stores in 20 states selling to both do-it-yourself and professional contractor customers. Lumber accounted for about 50 percent of its sales. The retail locations were served by its eight distribution centers. Its sales for the fiscal year ending November 29, 1997 were \$2.3 billion. Payless filed under Chapter 11 of the Bankruptcy Code on July 21, 1997.

66. Strober sold building materials primarily to professional contractors from its 11 building supply centers located in New York, New Jersey, Pennsylvania and Connecticut. Its stores averaged about 40,000 square feet. About one-half of its stores are leased. The most recent Form 10-K in the record reveals that its sales for the year ending December 31, 1995 were \$126 million.

67. White Cap marketed its tools and materials primarily to professional contractors from its 40 branch locations in the western United States. All of its facilities are leased. It also markets its products through an outside sales force, catalogue orders and a centralized “fulfillment center.” White Cap’s sales for the fiscal year ending March 31, 1998 were \$187 million.

68. Wolohan maintained 50 building material stores in Illinois, Indiana, Kentucky, Michigan and Ohio catering to builders, remodelers and do-it-yourself customers. Its sales for the year ending December 31, 1997 were \$425 million.¹

¹ For the sake of comparison of sales, Home Depot’s sales for the fiscal year ending February 1, 1998 were \$ 24.1 billion dollars, while the combined sales of LHC and LCI for the fiscal year ending January 30, 1998 were \$ 10.1 billion dollars.

69. AA obtained financial data for LHC and the foregoing selected companies for the period 1992 through 1999. The financial data for LHC that Mr. Snyder used in the 2002 CPM study was limited to unaudited internal data from the LHC income statements and balance sheets, along with trial balance information.

70. The market to book value ratio (“M/Bvr”) is a measure of value, created or destroyed, that is equal to the present value in dollars an investor receives for each dollar invested. The M/Bvr depicts a rank ordering of economic performance which correlates with the excess returns the company is earning or not earning, as the case may be. A M/Bvr greater than one indicates the company is expected to earn excess returns on invested capital, while a M/Bvr that is less than one indicates that such earnings will be sub-par. The following chart sets forth the M/Bvr for 1996, 1997 and 1998, as determined by Dr. Alan C. Shapiro, the Division’s witness, in his report (exhs. 15, 15.1), relating to Home Depot, Lowe’s and 9 of the 11 proposed comparable companies investigated by AA in connection with its 2002 CPM study, and for which data was available to Dr. Shapiro.

Company	1996	1997	1998
Home Depot	3.99	6.24	10.21
Lowe’s	2.59	3.41	6.56
Building Materials	1.00	.80	.85
DIY	.87	.51	.06
Eagle	1.81	1.61	2.30
Hechinger	.23	—	—
Home Base	1.41	.71	.66
National	.43	.62	.78

Orchard	---	---	---
Payless	.30	.01	.19
Strober	---	---	—
White Cap	—	3.62	1.50
Wolohan	1.03	.65	.80

71. American Appraisal Associates (“AAA”) was retained to prepare a transfer pricing study to determine whether the royalty paid under the license of the marks by LF to LHC and LCI was within an arm’s-length range under section 1.482 of the Treasury Regulations.

72. Richard J. Billovits, a vice president and principal of AAA, conducted the study. He holds an MBA in finance from St. John’s University. He has about 12 years experience in the valuation of intangible property, including trademarks, and has worked on transfer pricing studies relating to trademarks and other intangible property. Mr. Billovits was accepted as an expert in the valuation of intangible assets and in transfer pricing, but was not offered or received as an expert in IRC § 482 matters.

73. Mr. Billovits gave testimony regarding the methods used and conclusions reached in the study. His report, dated as of January 31, 1997 and January 31, 1998, was received in evidence. In the course of preparing to conduct the study, Mr. Billovits reviewed various financial and other documents regarding the operations of LHC and LF. He visited LCI’s headquarters in Wilkesboro, North Carolina; LF’s office in Wilmington, Delaware, and three stores located in New York, New Jersey and North Carolina. Mr. Billovits also spoke with certain executives of LCI and LF. He determined that the CUT method was the best method to use to determine the appropriate range of arm’s length royalty rates.

74. In order to find comparable license agreements entered into by uncontrolled parties, Mr. Billovits looked to various sources including Intellectual Property Research Associates, the RoyaltySource Intellectual Property Database, Home Improvement Research Institute, and Bonds Franchise Guide 1999. He also reviewed various Forms 10-K filed by companies in the home improvement industry.

75. Mr. Billovits found two license agreements that he considered to be comparable. One such agreement was the October 17, 1995 agreement whereby AMRE was granted the use of the Century 21 trademarks. This is the same agreement selected by AA as a CUT which is referenced in Finding of Fact “27”. The second agreement determined by AAA to be comparable was the Ace Hardware Corp. (“Ace”) franchise agreement, as reported in Bond’s Franchise Guide 1999, which granted franchise rights to various franchisees. This is the same franchise agreement referred to in Finding of Fact “28”, which agreement was relied upon by AA in its 2000 transfer pricing report, and then rejected by AA as a CUT in its 2002 study referenced in Finding of Fact “49”. In return for these rights, the franchisee would pay Ace a 2 percent of gross sales royalty plus an advertising fee of 1.3 percent, all in addition to an initial non-refundable franchise fee of \$25,000.00 for the first store and \$15,000.00 for each additional store.

76. Based on these CUTs, AAA determined the arm’s-length royalty rate range to be from 2 to 3 percent. In order to test its findings under the CUT method, AAA next employed a CPM analysis. Under this method and using the Lowe’s consolidated companies as the tested party, AAA searched 15 SIC codes in various sources and data bases, which search yielded 104 companies. An examination of short business profiles of the 104 companies to compare their

business operations with those of LHC served to reduce the list of potential comparable companies to 14.

77. AAA next screened the 14 companies based on a number of factors intended to exclude companies that, among other things, owned valuable trademarks or engaged in major manufacturing activities or were not United States companies conducting business primarily in the United States or were in financial distress or did not derive most of their revenue from the sale of home improvement products. This screening process reduced AAA's list of potential comparable companies to seven, including six of the companies selected as comparable companies by the AA analysis (Building Materials, DIY, Homebase, National, Wolohan and White Cap) plus Wickes, Inc. ("Wickes"). Homebase had changed its name to House-2-Home, Inc. since the AA study. Mr. Billovits advised that Home Depot was excluded because it owned valuable trademarks.

78. AAA next determined the operating margin and the rate of return on operating assets of each company in this group of seven and then made adjustments for differences in inventory valuation methods as well as nonrecurring and nonoperating items. Using Lowe's audited consolidated numbers, AAA adopted the Lowe's operating margin as the profit level indicator and used the rate of return on operating assets for confirmation.

79. According to Mr. Billovits, by assuming the payment to LF by LHC of a three percent royalty rate, and comparing LHC's operating margins and rates of return on operating assets with the interquartile range of these results for the seven companies for the years 1996, 1997 and 1998, LHC's operating margins and rates of return on operating assets were within or higher than the interquartile range of each measurement in each year. Based on its CPM study,

AAA concluded that LHC could pay a 3 percent royalty to LF for its use of the marks and remain within or above the interquartile range of the seven companies, which, in turn, demonstrates that a 3 percent royalty rate would be arm's length. Thus, according to Mr. Billovits, if a 3 percent royalty rate is arm's-length, then, of necessity, so is the 2.5 percent royalty that LHC was actually paying to LF during this period.

80. In conducting its CUT study, AAA failed to comply with the Treasury Regulation requirement that the intangible property involved in the controlled transaction be comparable to the intangible property involved in each of the uncontrolled transactions by demonstrating that both sets of intangibles have a similar profit potential through the direct calculation of the net present value of the benefits to be realized through the use of the intangible property.

81. The Division presented the testimony of Alan C. Shapiro, Ph.D., whose written report, dated June 3, 2002, was received in evidence. Dr. Shapiro has a Ph.D. in economics from Carnegie Mellon University and has taught economics and finance for more than 25 years. He is the Ivadelle and Theodore Johnson Professor of Banking and Finance at the Marshall School of Business of the University of Southern California ("USC"). At USC he served as chairman of the Department of Finance and Business Economics. Dr. Shapiro was accepted as an expert in economics, corporate finance, valuation of intangibles and transfer pricing. He did not purport to be and was not offered as an expert in IRC § 482 principles.

82. Dr. Shapiro, in his testimony and report, criticized the AA and AAA royalty rate studies and concluded that LF's trademarks had little intrinsic value and could be replaced at relatively low cost. He asserted that the AA and the AAA CUTs were not comparable to the LHC/LF licensing agreement; the royalties paid by LHC extracted too great a portion of its

operating income for the period 1991 through 2000 and prevented LHC from earning its cost of capital on its tangible and intangible assets; that contrary to the positions of AA and AAA, LHC did own unique and valuable intangible assets, without which the marks owned by LF would be all but worthless; and the CPM analyses ignore the fact that LHC was operating in an industry in transition with few winners (Lowe's and Home Depot) and many losers. Dr. Shapiro explained that not all excess returns a company may earn are attributable to its trade names. He discussed competitive advantages that earn excess returns and take the form of either cost based advantages or product differentiation. In his report, Dr. Shapiro also discussed barriers to entry by competitors, the ability to innovate, the role of trademarks as a signal to consumers, and the tendency of a trademark to become stale and to require frequent refreshment.

83. Dr. Shapiro estimated the weighted average cost of capital ("WACC") of the Lowe's consolidated companies for the period from 1991 to 2000. He determined from his estimated computation that Lowe's residual income was insufficient to pay a royalty to LF of more than .7 percent in 1996 and .8 percent during 1997.

84. Dr. Shapiro testified that LHC owned unique and valuable intangible assets that included a distribution network, marketing know-how, logistics know-how, assembled workforce, employee goodwill, favorable store locations, economies of scale in purchasing and advertising, good relations with suppliers, and the ability to provide quality service. He did not fix the value of these intangibles. Dr. Shapiro postulates that where a licensor that owns a trade name that he licenses to a licensee, who himself owns valuable intangible assets that substantially increase the returns from the use of the trade name, in such a case any excess

returns earned are attributable both to the assets owned by the licensor as well as those owned by the licensee.

85. The Division presented the testimony of Ednaldo A. Silva, Ph.D. Dr. Silva did not submit a transfer pricing report. His Ph.D. is in economics and is from the University of California at Berkeley. Dr. Silva, a Fullbright Scholar and professional economist, taught economic development and statistics at the New School for Social Research. He was later employed by the IRS as an industry economist. He then transferred to the Office of Chief Counsel of the U.S. Department of the Treasury where he served on the Section 482 Regulation Drafting Team. He authored a chapter of the Transfer Pricing Handbook (Feinschreiber, ed., 3rd ed. 2001). At the time of his testimony he was a director of LECG, a group engaged in economic and financial consulting. He was accepted as an expert in economics, transfer pricing and IRC Section 482 principles.

86. In his testimony Dr. Silva described a preaudit technique from the Internal Revenue Manual that he employed to screen for potential transfer pricing problems. The screening process begins with the review by the examiner of financial statements and the tax returns of the parties to the transaction. Next the examiner must calculate financial ratios from the information gleaned from the returns and compare these ratios to industry norms to determine if there are substantial deviations from these norms. By the application of this process, he determined that LHC was producing an operating margin that was lower than the industry norm. Dr. Silva also computed LF's operating profit margin, which he determined was over 99 percent for the years at issue. Based on his experience he found this profit margin to be extraordinary even before comparing it to industry norms. Dr. Silva cautioned that producing a transfer pricing report that

purports to establish an arm's-length consideration without having an analysis of both parties is not persuasive.

87. Dr. Silva next examined LF's revenues and expenses and noted that the disparity between those revenues and expenses was implausible in relation to its functions, assets employed and risks assumed. He noted that LF did not incur the type of expenses, such as advertising, ordinarily associated with maintaining or enhancing the value of trademarks. Dr. Silva stated that LHC needed \$6 billion in sales in order to generate \$168 million in profits, whereby LF only needed to make \$168 million in sales to realize \$168 million in profit. From this analysis of LF's finances Dr. Silva concluded that distortion of income was present.

88. Dr. Silva stated that when applying the CPM with LHC as the tested party, the use of companies as comparables that are much smaller than LHC in a segmented market gives rise to an operating profit margin that does not reflect the excess profits attributable to LHC's market share. He maintained that such an approach diverts significant operating profit to LF that is not commensurate with the value of its marks. Dr. Silva stressed the importance of performing a functional analysis, a risk analysis and a contractual analysis, among other factors, to determine whether a party to an uncontrolled transaction is comparable to the tested party. He also noted that where a licensee adds value to the licensor's intangible property by bearing the cost of advertising services, then, under IRC Section 482, the licensor must compensate the licensee at an arm's-length rate.

89. Dr. Silva concluded that because the CPM does not segregate the income attributable to LF's marks from income attributable to LHC's factors of excess profit, particularly its unique and valuable intangible assets, that the profit split method ("PSM") would

provide a more reliable result pursuant to the best method rule of the 1994 Treasury Regulations. Dr. Silva did not perform a PSM study. He claims that attributing all the excess profits to the trademarks without measuring the other components which may have contributed to the excess profits leads to a biased result.

90. Dr. Silva testified that the AA and AAA CUTs did not satisfy the requirements set forth in the 1994 Treasury Regulations because the intangible assets for which royalties were paid in each of these CUTs were not shown to have similar profit potential to the intangible assets licensed by LF to LHC, and the intangible assets being compared could not pass, in the alternative, the smallness test, which, he states, is required before one may resort to a comparison of profits based upon factors set forth in Treasury Regulation § 1.482-4(c)(2)(iii)(B)(2). Dr. Silva asserts that the AMRE agreement with Century 21, the ACE franchise agreement, and the AMRE agreement with Sears relied upon by AA and AAA as being comparable to the LF licensing agreement with LHC are not comparable for various reasons, including functional differences, territorial differences covered by operations, duration of agreements and differences as to the party responsible for advertising costs, among others.

91. Petitioner presented the testimony of William J. Coyle, Ph.D. in rebuttal to the Division's experts. Petitioner also submitted into evidence two reports prepared by Dr. Coyle, one dated October 11, 2002 in rebuttal to the testimony of Dr. Silva, and the other dated November 4, 2002 in rebuttal to the report and testimony of Dr. Shapiro.

92. Dr. Coyle holds a Ph.D. in economics as well as a J.D. from the University of Maryland. He has extensive experience with IRC § 482 transfer pricing issues and, at the time

he gave testimony, was the site leader of PriceWaterhouseCoopers transfer pricing practice in New York City. He was accepted as an expert in economics and IRC § 482 transfer pricing.

93. In preparation for his testimony and reports, Dr. Coyle reviewed LHC and LF financial information, the AA and AAA transfer pricing reports, Dr. Shapiro's report and the testimony of Dr. Silva and various witnesses for petitioner.

94. Dr. Coyle testified that the best method for evaluating the royalty paid by LHC to LF during the tax years at issue was the CPM. He found the CUT method used by both AA and AAA in their transfer pricing reports to be less reliable than the CPM, but opined that the CUT method did provide a general benchmark in support of the conclusions reached by AA and AAA under the CPM. Dr. Coyle stated that the return on capital employed was the most appropriate profit level indicator under the CPM, but that his conclusion would remain unchanged if the return on sales or the gross margin to operating expense ratio ("Berry ratio") was used as the profit level indicator.

95. Dr. Coyle testified that the WACC analysis performed by Dr. Shapiro was less reliable than the CPM because the WACC analysis relied exclusively on internal data and did not include any comparison of the financial results of LCI, LHC or LF with the results of the uncontrolled transactions or companies under comparable circumstances.

96. Dr. Coyle stated that Dr. Shapiro computed a WACC that was too high, and that by using Lowe's consolidated financial results and market value, Dr. Shapiro included the value of the marks in his WACC computation. This, according to Dr. Coyle, overstated the cost of capital and understated the residual amount available to pay a royalty for use of the marks.

97. In response to Dr. Shapiro's position that LHC owned valuable intangible assets, Dr. Coyle stated that the intangible assets described by Dr. Shapiro are not protectable and can be copied. He noted that the 1994 Treasury Regulations are very vague, leaving it to a facts and circumstances test as to what constitutes a valuable nonroutine intangible asset.

98. Dr. Coyle testified regarding Dr. Shapiro's position that the CPM was inappropriate in an industry in transition, stating that this position is not supported by the Treasury Regulations. Dr. Coyle did, however, agree with Dr. Shapiro that the CUTs asserted by AA in their 2000 and 2002 studies and by AAA in its study are less reliable than other methods because the CUT method does not look at the profit potential of the licensed property. In addition, Dr. Coyle stated that the interquartile range of financial results of companies in the general retail area selected by AA and AAA did not vary significantly from companies in the retail home improvement industry.

99. Dr. Coyle also disagreed with Dr. Silva's view that LF's financial results did not reflect arm's-length dealing. Dr. Coyle noted that Dr. Silva, in his analysis, used the book value of the marks rather than their fair market value. According to Dr. Coyle this caused LF's rate of return on assets to be substantially overstated.

100. Dr. Coyle disagreed with Dr. Silva's claim that the best method was the PSM. Because LHC had no unique and valuable intangible assets, Dr. Coyle believed that the CPM was the best method, using LHC or LHC and LCI combined as the tested party.

101. Dr. Coyle tested the CPM analyses conducted by AA and AAA. He performed separate tests for (a) the five companies used by AA in its 2000 study; (b) the 11 companies used by AA in its 2002 study; (c) the seven companies used by AAA in its 2002 study; (d) the 20

companies whose Forms 10-K were placed into evidence by the Division; (e) the 64 companies listed by Compustat in the relevant 4-digit SIC code; (f) the 88 companies in the relevant 3-digit SIC code; and (g) the 262 companies listed under the 2-digit SIC code for retail distribution. Dr. Coyle then computed the interquartile range for each set using three profit level indicators for 1996, 1997 and 1998. He noted that as to the latter three sets, notwithstanding the fact that their comparability to the Lowe's operation was very rough, their interquartile range was relatively stable. These analyses, although not conducted in accordance with IRC § 482 principles, showed that LHC, in almost all instances, was within the interquartile range after payment of the royalty to LF. Dr. Coyle expressed his opinion that this consistency of results demonstrated the stability of the ranges in the AA and AAA studies and reinforced their respective conclusions that, after payment of the royalty, LHC was earning an arm's-length return. Dr. Coyle performed no comparability analysis with LHC, LCI or LF on any of the companies he examined and looked at no Forms 10-K. In his analysis Dr. Coyle used the Lowe's consolidated numbers from the Compustat database after subtracting the royalty.

102. Petitioner presented the testimony of Irving H. Plotkin, Ph.D., in rebuttal to the Division's experts, and submitted into evidence a report prepared by Dr. Plotkin, dated October 2002, in rebuttal to Dr. Silva's testimony. Dr. Plotkin earned a Ph.D. in mathematical econometrics from the Massachusetts Institute of Technology. He has extensive experience with IRC § 482 transfer pricing issues and has acted as a consultant to both the IRS and the U.S. Treasury Department. He has testified as an expert in several state and Federal cases involving transfer pricing. Dr. Plotkin is a managing director in the transfer pricing group of PriceWaterhouseCoopers. Although he was never employed by the IRS, Dr. Plotkin served as an

advisor to people who were involved in the writing of the White Paper as well as drafts of the Treasury Regulations. He was accepted as an expert in microeconomics, transfer pricing, IRC § 482, financing and accounting.

103. In preparation for his testimony and report, Dr. Plotkin reviewed financial information relating to LCI, LHC and LF; testimony of Dr. Silva and certain fact witnesses; the various AA and AAA reports; and Dr. Shapiro's report and testimony.

104. Dr. Plotkin was critical of the WACC analysis performed by Dr. Shapiro. Dr. Plotkin opined that Dr. Shapiro was incorrect in including the value of the marks in a computation which was being used to determine the royalty rate to be paid for the use of those marks. He pointed out that an arm's-length royalty rate is not a function of the capital structure of the licensee, and that the WACC approach used by Dr. Shapiro is inconsistent with an arm's-length pricing method because different capital structures can lead to different results.

105. Dr. Plotkin testified that when using the CUT method, one must be certain that the profit potential of the parties is the same. He expressed his preference for the CPM and the use of the return on capital employed profit level indicator because you do not need functional comparability.

106. Dr. Plotkin testified that the PSM was not the "best method" because LHC did not have unique and valuable intangible assets. He stated that in order for the PSM to be considered the best method under the Treasury Regulations, both companies must have unique and valuable intangible assets.

107. Dr. Plotkin stated that there was no justification under the 1994 Treasury Regulations to support the testing of LF by Dr. Silva. He maintained that under the regulations

the tested party must be determined before selecting the method, and that both the regulations and the Internal Revenue Manual point to LHC as the tested party. Dr. Plotkin maintained that the Internal Revenue Manual, unlike the Treasury Regulations, is not authoritative for use in court proceedings.

108. Dr. Plotkin agreed with Dr. Coyle that Dr. Silva's use of the book value rather than the fair market value of the marks in his testing of LF had the effect of substantially overstating LF's return on assets. Dr. Plotkin observed that it was not unusual for companies holding unique valuable intangible assets to have an operating profit close to 100 percent.

109. Dr. Plotkin took issue with Dr. Silva's preaudit screening of LF as being contrary to section 482 standards. He noted that because LF owns unique and valuable intangible assets, it cannot be the tested party in a section 482 CPM analysis. He disagreed with Dr. Silva's choice of securities brokers and dealers as comparable entities, and noted Dr. Silva's failure to make any adjustments for capital intensity as required by the regulations. Dr. Plotkin also stated that Dr. Shapiro misapplied the capital asset pricing model ("CAPM") in his computation of the WACC. He asserted that Dr. Shapiro erred by using a 30-year rate rather than the much shorter term treasury bill rate as the risk-free rate in his CAPM computation.

110. Dr. Plotkin conducted a test of the AA and AAA CPM analyses by determining the interquartile ranges of operating rates of return for 209 retail companies for the years from 1990 to 1999 using a 10-year weighted average taken from the Standard & Poor's Compustat database. He had no specific knowledge of the particular operation of any of the 209 retailers, or the product line each sold. Dr. Plotkin found that, after payment of the royalty, LHC's operating rates of return for the tax years at issue were 6 percent for tax year 1996 and 8 percent for tax

year 1997. He also found that these rates of return fell within the 10-year weighted average and within the interquartile range of the 209 companies for 1995, 1996, 1997 and 1998 and were arm's-length under IRC § 482.

111. According to Dr. Plotkin, economies of scale are a factor that must be considered when choosing comparables. He determined that there is no simple linear relationship between economies of scale and the rate of return.

112. Dr. Plotkin testified that IRC § 482 has been with us in one form or another since approximately 1911, and that the standard to be applied, the price used, must be selected as if the parties to a controlled transaction were unrelated. He stated that it is irrelevant how the amount of the royalty is arrived at as long as it meets the arm's-length standard.

113. During the tax years at issue the functions performed by petitioner and LCI included:

- (1) purchasing home improvement products from unrelated manufacturers and distributors;
- (2) distribution, logistics and inventory management;
- (3) marketing and selling home improvement products to customers; and
- (4) providing customer service and installation services.

114. LF did not perform any of these functions during the tax years at issue. Its primary functions included some trademark quality control functions, approving new trademarks, reviewing its investment portfolio performance, approving common stock dividends to be paid to LCI, reviewing new license agreements, examining its quarterly financial statements and discussing the status of various state tax matters.

115. Market risks faced by petitioner and LCI during the tax years at issue included fluctuations in costs, demand, prices, inventory availability, and interest rates. Other risks they shared included credit, collection and general business risks related to ownership of property, stores and equipment. During the tax years at issue LF shared some of the market risks with petitioner and LCI, because LF's royalty income was based on a percentage of petitioner's and LCI's sales.

116. Robert Niblock, the executive vice-president and chief financial officer of LCI and LHC, presented testimony on behalf of petitioner. At the time of his testimony, he also served as president and chairman of the board of LF. During the tax years at issue he held the title of senior director of taxation for LCI with responsibilities that included being familiar with all state and Federal tax matters involving all Lowe's affiliates. Mr. Niblock discussed LF's state tax burdens and the strategy of Lowe's to enter larger markets and to compete with Home Depot and other building supply retailers by constructing larger, cleaner, brighter stores selling a greater variety of products at a higher profit margin, yet at competitive prices.

117. David Green, an assistant treasurer for LCI and the treasurer for LF, gave testimony for petitioner. Mr. Green, who had been employed by LCI since 1995, discussed details of the 1989 Lowe's corporate reorganization and the profitability of the New York stores during the tax years as reflected in separate store financial statements.

118. Gaither M. Keener, Jr., a vice-president, assistant secretary and assistant general counsel for LCI and LHC, testified on behalf of petitioner. Mr. Keener's testimony included his concerns regarding the Lowe's corporate structure in the 1985 to 1987 time frame, his role in the 1989 Lowe's corporate reorganization, the formation of LF and the drafting of the license

agreements permitting the use of the marks by LHC and LCI. In November 1998 Mr. Keener was elected to the LF board of directors and appointed as LF's senior corporate counsel.

119. Lee Herring, a senior vice-president of distribution for LCI, was called as a witness by petitioner. He holds a BS in business administration from the University of North Carolina at Chapel Hill. Mr. Herring gave testimony regarding the evolution of Lowe's regional distribution centers from low tech conventional buildings to modern, high technology, state-of-the-art 800,000 to 900,000 square foot structures, each costing upwards of \$45 million to build, with miles of conveyor belts and off-the-shelf software to keep track of each piece of merchandise. The goal of each of the five modern, well-run Lowe's distribution centers is to keep the stores it serves in stock, but with less inventory in the store and in the system, resulting in lower costs and higher margins.

120. Van Beam testified on behalf of petitioner. Mr. Beam holds a BS in business administration, and has worked for LCI since 1978. At the time of his testimony he worked for LCI's Internal Audit Department as its director of store audits. He testified that each of LHC's stores is responsible for employee training, and each employee receives training every week.

121. Martha Barber testified for petitioner. She is a graduate of the Wake Forest University Law School and a partner in the law firm of Alston & Bird. She is the chair of the firm's trademark and copyrights practice group. Ms. Barber explained the trademark registration process, the need for the renewal of trademark registrations, licensing, the importance of quality control and the respective roles of LCI and LF in the development and registration of LF's marks. She was accepted as an expert in intellectual property matters.

122. The LF board of directors, in July 1996, consisted of Richard D. Elledge, Kenneth A. Neal, Leonard G. Herring, William C. Warden, Gordon Cadwgan, Gordon W. Stewart, David Dupert, and Arden Engebretsen. At this time, Messrs. Elledge, Neal, Herring, Warden and Cadwgan were employed by LCI and held various positions on the boards of or as officers of LCI and LHC. Mr. Dupert was a principal in Delaware Corporate Management, Inc., which handled the day-to-day operations of LF from its inception until Gisela Eubanks was hired by LF in 1995. Mr. Stewart, a Delaware attorney with a specialty in taxation, was the incorporator of LF in July 1989, and through his firm, Stewart & Associates, performed legal services for LF and LCI. Mr. Elledge was chief accounting officer and senior vice-president for LCI and LHC. Mr. Herring was president and chief executive officer of LCI and LHC, and had been LCI's first financial officer when he was hired by Lowe's in 1955. Mr. Neal was assistant treasurer of LCI and LHC. Mr. Warden was general counsel, secretary and chief administrative officer of LCI and LHC. Mr. Cadwgan was a long term director of LCI and LHC, who became Director Emeritus upon his retirement on June 30, 1996. His background is in finance and he was responsible for taking Lowe's public in 1961. Mr. Cadwgan was replaced on the LF board by Thomas E. Whiddon in December 1996. Mr. Warden was replaced on the Board by Gaither M. Keener, Jr. in November 1998. Mr. Neal was replaced on the board by Robert A. Niblock in November 1998. Messrs. Whiddon, Keener and Niblock were long term employees of LCI at the time of their respective elections to the LF board of directors.

123. During tax year 1996 LHC and LCI made royalty payments to LF in the sums of \$155 million and \$51.6 million, respectively, while in tax year 1997 the royalties paid by LHC and LCI were \$206 million and \$37.7 million, respectively. During tax years 1996 and 1997 LF

paid to LCI, its sole shareholder, stock dividends in the respective sums of \$162.7 million and \$229 million. During tax years 1996 and 1997 LHC paid to LF as interest on the CAFCO loans the respective sums of \$113.8 million and \$115.9 million.

124. Petitioner has conceded that the stock ownership test of 20 NYCRR 6-2.2(a) and the unitary business test of 20 NYCRR 6-2.2(b) have both been met by the Division. Petitioner has also conceded the existence of substantial intercorporate transactions between LF and petitioner during the tax years. Left for resolution is the question of whether petitioner has successfully rebutted the presumption of distortion of 20 NYCRR 6-2.3(a), which arises where a taxpayer reports its income on a separate basis despite having substantial intercorporate transactions with one or more related corporations.

125. During the course of the hearing and prior to the conclusion of the testimony of petitioner's two expert rebuttal witnesses, the Division requested leave to recall Dr. Shapiro and Dr. Silva to the witness stand to rebut the testimony of petitioner's rebuttal witnesses. The Administrative Law Judge declined to accept further testimony, but agreed to hold the record open for the receipt of affidavits from the two Division experts, as well as responding affidavits from petitioner. Upon the timely receipt of the post-hearing affidavits of Dr. Silva and Dr. Shapiro, petitioner moved by notice of motion dated December 31, 2002, for an order striking the two affidavits from the record. By order dated January 30, 2003, the Administrative Law Judge granted petitioner's motion to strike and excluded the two post-hearing affidavits from the record on the grounds that the affidavits served no useful purpose in this proceeding.

126. By notice of motion dated February 26, 2003, the Division moved for an order granting leave to reargue and/or to renew petitioner's earlier motion to strike, and for an order

denying petitioner's motion and receiving the post-hearing affidavits of Dr. Silva and Dr. Shapiro into the record. By order dated March 27, 2003, the Administrative Law Judge granted the Division's motion for leave to reargue, and upon the reargument thereof, the prior order of the Administrative Law Judge was adhered to.

127. The following proposed findings of fact submitted by petitioner were not adopted for the reasons stated:

(a) Proposed findings of fact 46 through 51, 54, 57, 71 and 72 state conclusions rather than facts;

(b) Proposed findings of fact 60 and 74 through 78 are not relevant to the issues presented for the tax years in question;

(c) Proposed findings of fact 32, 39, 71, 72 are not supported by the record.

128. The following proposed findings of fact submitted by the Division were not adopted for the reasons stated:

(a) Proposed findings of fact 59, 68 and 74 state conclusions rather than facts;

(b) Proposed findings of fact 62, 86, 105, 141, 143, 209, 287, 288, 289, 290, 291, 292, 294, 338, 339, 347, 348, 351, 352, 354, 355, 359 and 360 are not relevant to the issues presented for the tax years in question;

(c) Proposed findings of fact 66, 73, 140, 176, 207 and 219 are not supported by the record.

CONCLUSIONS OF LAW

A. Article 9-A of the Tax Law imposes a franchise tax on all domestic and foreign corporations doing business, employing capital, owning or leasing property, or maintaining an office in New York State (Tax Law § 209[1]). The franchise tax is based on the taxpayer's

entire net income (“ENI”). ENI is generally the same as the taxpayer’s Federal taxable income with certain modifications, and consists of two components, business income and investment income. Business income is equal to ENI less investment income (Tax Law § 208[8]), and is allocated to New York State by multiplying the taxpayer’s business income by its business allocation percentage (“BAP”) as defined in Tax Law § 210(3)(a). In order to properly reflect a taxpayer’s franchise tax liability, Tax Law § 211(4) gives the Division the discretion to require or permit corporations subject to New York State franchise tax to file combined reports with certain other corporations. The statute requires that the taxpayer either own or control substantially all of the stock of the other corporations, or the taxpayer’s stock be substantially owned or controlled by such other corporations. The statute further limits the Division’s discretion by providing that

no combined report covering any corporation not a taxpayer shall be required unless the [Division] deems such a report necessary, because of inter-company transactions . . . in order to properly reflect the tax liability under this article (Tax Law § 211[4].)

The Division’s regulations provide that it may require or allow the filing of a combined report where three conditions are met: (1) a stock ownership test (20 NYCRR 6-2.2[a]); (2) a unitary business test (20 NYCRR 6-2.2[b]); and (3) a distortion of income test (20 NYCRR 6-2.3). The distortion of income test provides, in part, that the Division:

may permit or require a group of taxpayers to file a combined report if reporting on a separate basis distorts the activities, business, income or capital in New York State of the taxpayers. The activities, business, income or capital of a taxpayer will be *presumed* to be distorted when the taxpayer reports on a separate basis if there are substantial intercorporate transactions among the corporations (20 NYCRR 6-2.3[a] [emphasis added]).

Substantial intercorporate transactions exist “where as little as 50 percent of a corporation’s receipts or expenses are from one or more qualified activities described in this subdivision (20 NYCRR 6-2.3[c]).” The qualified activities referenced include the performance of services for other corporations in the group. The presumption of distortion may be rebutted by the taxpayer, who has the burden of proof, and who must demonstrate that the transactions between it and its related corporations are at arm’s-length through the use of IRC § 482 adjustments that show arm’s-length pricing (*Matter of USV Pharm. Corp.*, Tax Appeals Tribunal, July 16, 1992; *Matter of Standard Mfg. Co.*, Tax Appeals Tribunal, February 6, 1992). The Division has the burden in nonpresumption cases and cases where the taxpayer has rebutted the presumption of distortion to show why reporting on a separate basis does not properly reflect income (*Matter of Silver King Broadcasting of N.J., Inc.*, Tax Appeals Tribunal, May 9, 1996). The Tribunal held in *Matter of Campbell Sales Co.* (Tax Appeals Tribunal, December 2, 1993), that it was at liberty to apply IRC § 482 principles, in the absence of section 482 adjustments by the parties, to determine the existence of arm’s-length pricing.

B. It is the Division’s position that LF must be included in a combined report with petitioner because there exists an “agreement, understanding or arrangement” under Tax Law § 211(5) in the form of the license agreement between petitioner and LF, as well as the assignment of the Lowe’s trademarks by LCI to LF and the license-back of those marks by LCI from LF. The Division contends that these two agreements have caused petitioner’s “activity, business, income or capital” within New York to become improperly or inaccurately reflected within the contemplation of the statute. The effect of these agreements, according to the

Division, is to divert taxable income out of New York in the form of excessive royalties paid by petitioner to LF.

C. The purpose of IRC § 482 is to prevent the avoidance of taxes by ensuring that taxpayers clearly reflect income attributable to controlled transactions (Treas Reg §1.482-1[a][1]). In order to determine the true taxable income of a controlled taxpayer, the standard to be applied is that of a taxpayer dealing at arm's-length with an uncontrolled taxpayer (Treas Reg § 1.482-1[b][1]). In selecting the best method to use in determining the most reliable measure of an arm's-length result, the two primary factors to be considered are the degree of comparability between the controlled transaction and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis (Treas Reg § 1.482-1[c][2]).

D. The 1991 AA royalty rate valuation appraisal had no relevance to the fixing of an arm's-length royalty rate to be paid by LHC to LF in tax years 1996 and 1997. The 1991 valuation was not presented as a section 482 study, and because it did not rely on a functional analysis of specific companies as potential comparables, but instead was limited to a broad industry overview, it did not comply with the section 482 regulations. The AA 1997 royalty rate valuation report purportedly relied on the CUT method of Treasury Regulation § 1.482-4(c) as the "best method" selected in accordance with section 1.482-1(c). The report initially named as comparable companies six home improvement centers and hardware stores, two of which AA eliminated. AA did not subject the four remaining companies to an analysis of the comparability factors required by Treasury Regulation § 1.482-4(c)(2)(iii)(A) for the purpose of confirming that the four uncontrolled taxpayers engaged in comparable transactions under comparable circumstances to the Lowe's consolidated companies. Nor did AA make any attempt to establish that the intangible assets owned by the four uncontrolled companies had a similar profit potential

to the intangible assets owned by LHC. It follows that the 1991 and 1997 AA studies do not support a finding that the royalty rate paid to LF by LHC during the tax years at issue was arm's-length.

E. In its 2000 examination to determine whether the royalty rate paid by LHC to LF was arm's-length, AA selected the CUT method as the best method and searched multiple electronic data bases and print publications for potential comparable license agreements. These searches resulted in two agreements that AA deemed comparable to the LF-LHC agreement. The first such agreement was the October 7, 1995 AMRE-Century 21 license agreement, whereby AMRE agreed to pay Century 21 a royalty of three percent of net sales plus a \$10 million annual advertising fee in return for the use of the Century 21 trade name and logo to support AMRE's sales of home improvement products and services. The second agreement, the Ace Hardware franchise agreement, was considered by AA to be less reliable than the AMRE-Century 21 agreement because Ace Hardware may have licensed to its franchisees the use of intangible property other than its trade name and trademarks. It follows that there is a failure to demonstrate that the intangibles in the Ace Hardware agreement are the same as or comparable to the controlled transaction intangibles, and further, there is no showing that the Ace Hardware or Century 21 intangibles had a similar profit potential to the controlled transaction intangibles (Treas Reg § 1.482-4[c][iii][B][1][ii]). The importance of the profit potential test is explained in Practical Guide to U.S. Transfer Pricing, (Cole, at 8-40 - 8-41 [2nd ed. 2001]), in terms of the profit potential being equated to a licensor's interest in the anticipated stream of income to be generated by the licensee's exploitation of the intangible, stating:

[i]f there is not a reasonable expectation that two intangibles will generate similar income streams (ie., have similar profit potential) it is hard to image [sic] how the two intangibles could be "comparable," and,

therefore, why the uncontrolled transaction would be a reliable arm's length benchmark for the controlled transaction.

Petitioner's witness, Dr. Coyle, in his rebuttal report to the testimony of Dr. Shapiro (exh. AAF, p.3), stated:

[w]hile Prof. Shapiro cites a number of differences between the CUTs and the LF agreement, I am more concerned that there is nothing to compare the profit potential of these agreements to the profit potential of the LF agreements, an essential analysis by the 482 regulations and economic theory.

Dr. Coyle explained that CUTs are rarely used because a determination of profit potential requires information that is not in the public domain.

In the absence of a showing by petitioner that the respective intangibles have a similar profit potential, the CUT method cannot serve to meet petitioner's burden to overcome the presumption of distortion. This reasoning applies with equal force to the 2002 AA CUT analysis, as well as the 2002 AAA CUT analysis, where no evidence was presented in support of the trademarks of the tested party and those owned by the uncontrolled comparables having a similar profit potential.

F. For the purpose of confirming the results obtained through its use of the CUT method in 2000 and 2002, AA turned to the CPM, wherein the arm's-length royalty rate range is derived from functionally comparable uncontrolled entities whose profitability, as measured by a profit level indicator ("PLI"), is comparable to that of the tested party. AA performed a CPM analysis in 2000, and again in 2002, using in each instance as the PLI the operating margins of uncontrolled building materials retailers who, it determined, performed functions and bore risks similar to the functions performed and risks borne by the Lowe's consolidated companies in respect to the 2000 analysis, and by LHC as to the 2002 analysis. In order to compute the arm's-

length range of royalty rates to be paid by LHC to LF, it is necessary to first determine the actual operating margin earned in each year at issue by LHC, after payment of the royalty to LF, and then compare each such operating margin to the arm's-length range of operating margins earned by the uncontrolled retailers in each corresponding year. Because the tested party selected by AA in its 2000 CPM transfer pricing study was Lowe's consolidated companies, which included the highly profitable LF, and the numbers used were taken from the Lowe's Federal consolidated returns for the fiscal years at issue, and because the Lowe's consolidated companies were not, as a group, a participant in the controlled transaction as required by Treasury Regulation § 1.482-5(b)(2), the Lowe's operating margin used in the comparison with the uncontrolled retailers' range of operating margins for each year at issue was other than the actual operating margin of LHC. It is for this reason that the AA 2000 CPM analysis fails to aid petitioner in meeting its burden of proof to overcome the presumption of distortion. The same reasoning applies with respect to the AAA CPM transfer pricing study, wherein AAA selected the Lowe's consolidated companies as the tested party, and used the Lowe's consolidated numbers to compute the Lowe's operating margin for the years at issue. With respect to the 2000 AA CPM analysis, the attempt by AA to construct an interquartile range of operating margins using only five numbers yielded an imprecise result, because the data eliminated from the top and bottom of the range of values did not even approximate the 25th and 75th percentiles of the range.

G. In the AA 2002 CPM analysis, the tested party selected was LHC. Mr. Snyder testified that the LHC financial information he relied on in his preparation of the 2002 transfer pricing report was segmented financial data taken from LHC's income statement and balance sheet information. Although he considered this information to be accurate and reliable, it was internal LHC data that was not audited. In *Matter of Tropicana Product Sales* (Tax Appeals

Tribunal, June 12, 2000), the Tribunal rejected a CPM analysis, in part, because the study was based on unaudited financial statements. The importance of having audited financial data may be gauged from the testimony of Mr. Billovits, who explained his choice of the Lowe's consolidated companies as the tested party in the 2002 AAA CPM study in terms of his having confidence in the consolidated financial results because their source was the audited financial statements.

H. Another area of concern bearing on the reliability of both the 2000 and the 2002 AA CPM analyses is the inclusion by AA of Hechinger Co. as one of the 11 purported comparable uncontrolled retailers in its 2002 analysis. Hechinger Co. had been excluded as a comparable retailer in the 2000 AA analysis because it owned valuable intangible assets. Mr. Snyder, when pressed as to whether he had changed his mind about Hechinger's ownership of valuable intangibles during the 2002 CPM study, stated that he had changed his mind and had changed the search criteria he employed. Mr. Snyder did not further explain the basis of either change.

In Practical Guide to U.S. Transfer Pricing (*supra*, at 9-9 & 9-10), it reads:

If the results of CPM are to be credible, the process by which potential comparable parties (are) identified should be as objective as possible. The criteria for identifying potential comparables should be clearly stated, and a reasonable effort to identify all companies meeting those criteria should be undertaken. Similarly, secondary criteria imposed to winnow out companies meeting the primary criteria must also be verifiable, economically meaningful, and, above all, fully disclosed. Full disclosure implies that a reader applying the stated criteria to the same sources of information would be able to identify the very same comparable companies.

The substitution of professional judgement in the place of an objective benchmark does not meet the required standard. The unexplained reversal of the AA position respecting Hechinger Co. ownership of valuable intangible assets serves to undermine the integrity of both of the AA CPM

analyses under review. It is also appropriate to note that Home Depot was rejected by AA as a comparable home improvement retailer in both the 2000 and the 2002 CPM studies because it owned valuable intangible assets. Because Home Depot and LHC so dominate the home improvement retail industry in terms of sales and market share, any CPM search criteria which finds LHC to be comparable to a number of weaker performing retailers, while excluding Home Depot as a comparable company, should be clear and definite, rather than vague and subjective. In *Matter of Sherwin-Williams Company* (Tax Appeals Tribunal, June 5, 2003), the Tribunal discussed the limitations of a search strategy that excluded high profit companies owning significant intangibles, the effect of which is to push down the interquartile range.

I. The AAA valuation report also excluded Home Depot from its CPM analysis because Home Depot owned valuable intangible assets. Although not part of the AAA report, Mr. Billovits testified that an additional reason for his having excluded Home Depot as a comparable company to LHC was that Home Depot was doing business in Canada, Mexico, Puerto Rico, Argentina and Chile, implying that such foreign markets may have a different economy, wage and price standards which can adversely impact comparability. Mr. Snyder also testified that Home Depot was eliminated because it did business in these foreign countries. The record, however, demonstrates that during the years at issue Home Depot was not yet operating stores in any foreign country other than Canada, where, according to its 1997 Form 10-K, 32 of its 624 stores were located. Certainly the impact of Home Depot having five percent of its retail operations in Canada has a reasonably ascertainable effect on profits, which effect can be eliminated through adjustments made in compliance with Treasury Regulation § 1.482-1(e)(2)(iii). Mr. Billovits also testified that of the 10 potential comparable companies identified in the AAA CPM study, Home Depot was the only company rejected for owning valuable

intangible assets. When asked how he concluded that the other companies did not own valuable intangible assets, Mr. Billovits stated that it was a “judgement call.” He admitted that he didn’t know whether the other companies did or did not own valuable intangible assets. The reasons given for the elimination of Home Depot as a comparable company by AA and AAA do not inspire confidence in the search criteria employed.

J. According to the 1997 Home Depot Form 10-K, Homer is the Home Depot trademark holding subsidiary, which licenses the use of the trademarks to the Home Depot operating subsidiaries. Homer appears to have much the same role within the Home Depot corporate family as LF has in the Lowe’s corporate structure, but is not mentioned in any of the transfer pricing studies. The search for companies that are comparable to LHC, LF or the Lowe’s consolidated companies is not advanced by systematically ignoring Home Depot and its subsidiaries.

In Dr. Shapiro’s analysis of the M/Bvr (market to book value ratio) of the 11 companies identified by AA in its 2002 CPM study as being comparable to LHC (Finding of Fact “70”), there was data available to Dr. Shapiro on nine of the companies for at least one of the three years. This data showed that eight of the nine companies were either in decline over the three years or unable to earn excess returns for one or more of the three years. None of the 11 companies has been shown to be comparable to LHC in terms of sales, number of stores or geographic markets served. The M/Bvr analysis confirms that at least 8 of the 11 companies were unable to realize or sustain any level of excess returns. In view of LHC’s continued robust growth in earnings, sales and new store openings, it is abundantly clear that none of the 11 companies selected by AA in its 2002 analyses can seriously be considered, under the CPM of section 1.482-5 of the Treasury Regulations, to be comparable to LHC.

Dr. Coyle's efforts to confirm the AA and AAA CPM results through the use of a large number of retail companies identified by four digit, three digit and two digit SIC codes without a comparability analysis, but using instead the interquartile range of different PLIs, only serves to demonstrate the ineffectiveness of employing statistical methods to support a basis for a finding of arm's-length pricing where the comparable companies are not carefully chosen (*see, Matter of Sherwin-Williams, supra*). Similarly, Dr. Plotkin's analysis of the operating rates of return of 209 retail companies wherein he determined that LHC's operating rates of return for each of the tax years under examination were within the interquartile range of the 209 companies for a four-year period that included calendar years 1996 and 1997, was also conducted with no comparability analysis, and is rejected for the same reasons. What is clear is that the conclusions reached in the AA 2000 and 2002 CUT and CPM studies, and in the AAA CUT and CPM studies, for the reasons stated, are insufficient to overcome the presumption of distortion.

K. The profit split method ("PSM") is available only in circumstances where the controlled companies, in this case LHC and LF, both own valuable nonroutine intangible assets. Petitioner maintains that the PSM is not the best method because, unlike LF, LHC does not own any valuable nonroutine intangible assets. Petitioner defines valuable nonroutine intangible assets far more narrowly than does the Division. Petitioner limits its definition of such intangible assets to trademarks and trade names that may be registered with the U.S. Patent and Trademark Office and protected by law from unauthorized use. Ownership of such valuable and unique assets permits the owner to earn excess profits. Routine intangible assets, according to petitioner, include such nonprotectable assets as an inventory management system, a store layout, a distribution system, in short, any intangible asset that could be duplicated and which is commonly required by all home improvement retailers in the operation of their businesses. Such

routine intangible assets, petitioner maintains, only generate routine, as opposed to excess, profits.

The Division does not recognize this distinction between routine intangible assets and nonroutine intangible assets. It urges that petitioner should have identified all the various categories of identifiable intangible assets and then measured the effect of each category, such as marketing intangibles, production intangibles and technology intangibles, on excess profits. Petitioner, according to Dr. Silva, the Division's expert, disregarded the possible effects on excess profits of these various other intangible assets, choosing instead to link all excess profits to a single class of intangible assets, the trademarks and trade names owned by LF.

L. A trademark or a trade name is an identifying name or symbol that serves to identify to the public the product or service that is being marketed under the trademark or trade name. Dr. Shapiro, in his report, asserted that such marks, standing alone, have little intrinsic value. It is, according to his report, the "critical complementary intangibles" that were not transferred to LF that are the real source of LHC's ability to earn excess profits. There are two principal groups of such intangible assets that help create value: organizational assets and technological assets. Organizational assets include management skills, marketing skills and Lowe's reputation for quality services and products. Technological assets include the knowledge and experience based assets such as the Lowe's distribution system, store layouts, and the ability to adapt to a changing marketplace. In his report, Dr. Shapiro opined that,

the income earned on a trademarked product increases with the amount of organizational capital supporting that mark. Hence, trade names and organizational assets are synergistic - each enhances the value of the other. Thus, any analysis that ignores a company's organizational assets will overvalue its trade names - and that overvaluation will be in direct proportion to the amount of its organizational assets (exhibit 15, p. 11).

In *Matter of Sherwin-Williams Company (supra)*, the Tribunal adopted this identical language from Dr. Shapiro's report received in evidence in that case, in support of its conclusion that that taxpayer's total valuable intangible assets were not limited to trademarks and trade names, but included the taxpayer's organizational assets as well. *Matter of Sherwin-Williams* supports the Division's premise that value is generated by the combined effect of a company's trademarks and trade names and its organizational assets as well.

M. A consideration of a company's goodwill and the relationship of goodwill to its trademarks and trade names is worthwhile. In *Philip Morris v Commissioner* (96 TC 606, *affd* 970 F2d 897), the U.S. Tax Court defined goodwill, in part, as "[t]he competitive advantage which . . . is represented by a number of property rights or interests, including tradenames, trademarks, customer routes and . . . distribution networks (citations omitted)" In *Nestle Holdings, Inc. v Commissioner* (70 TCM 683, 716, *revd on other grounds* 152 F3d 83), the U.S. Tax Court stated that "they [trademarks] do not equal goodwill and are only one straw in the bundle that makes up goodwill." Clearly, petitioner's claim that LF, by virtue of its acquisition of the Lowe's marks, thereby acquired all of the goodwill associated with the goods and services provided by the Lowe's stores is not supported by the authorities cited. Similarly, in *Nestles Holdings, Inc.*, the Tax Court determined that there were many reasons, other than trademarks and trade names, that account for why consumers purchased Carnation products (70 TCM, at 717). I find that there are many reasons other than the Lowe's trademarks and trade names owned by LF that bring customers into petitioner's stores to purchase the goods and services available for sale there. The record amply supports the conclusion that petitioner attracts its customers through a combination of quality, price and service (exhibit S-2, p.8).

These elements and others, along with the Lowe's trademarks and trade names it licenses from LF, are all components of petitioner's goodwill. It is petitioner's goodwill in all its forms that brings traffic into its stores. As indicated by Dr. Shapiro, trademarks, standing alone, have little intrinsic value. The substantial value that Lowe's trademarks and trade names share is generated by the attributes of quality, price and customer service that have become associated with the branded products and services that display the Lowe's marks (*see, Matter of Sherwin-Williams Company, supra*).

Citing to *Philip Morris v Commissioner (supra)*, in its reply brief, petitioner reasons that because the Tax Court found the element of going concern value to be worth only \$5 million of the \$80 million aggregate value of all Seven-Up intangible assets, and because petitioner, LHC, has going concern value, it necessarily follows that those elements of goodwill transferred to LF with the marks are valuable and nonroutine, while those elements of goodwill retained by LHC, which include going concern value, are not. I find that because the Tax Court determined that the excess earnings of *Philip Morris* were in part attributable to going concern value, such value was treated as a valuable intangible asset by the Tax Court. *Philip Morris* does not support petitioner's position. Nor do the section 482 regulations support petitioner's contention that going concern value is a routine intangible asset. Petitioner's reliance on *Canterbury v Commissioner* (99 TC 223) is also misplaced. In *Canterbury* the Tax Court held that going concern value was a nonamortizable intangible asset under IRC § 1253(d), which permits the amortization of a franchise, a trademark or a trade name. The Tax Court permitted the taxpayer to amortize the amount of the purchase price that was related to the purchase of a series of McDonald's franchises, but not the going concern value. Petitioner also questions the Division's

reliance on the Tax Court decision in *Nestle Holdings, Inc. v. Commissioner (supra)*, which, it claims, misconstrued *Philip Morris*. The Second Circuit in *Nestle Holdings* vacated the Tax Court's approval of the relief-from-royalty valuation method and remanded the matter to the Tax Court without any mention of goodwill or the Tax Court's definition thereof.

N. Having determined that LHC and LF both own valuable nonroutine intangible assets, and in view of the comparability issues alluded to in the various CPM and CUT studies discussed above, it is determined that, under Treasury Regulation § 1.482-1(c)(1), the residual profit split method of section 1.482-6(c)(3), as urged by Dr. Silva, is the best method of determining the proper apportionment of the combined residual profit between LHC and LF.

O. It is evident that the value of the trademarks and trade names owned by LF have been exaggerated in an effort to justify the payment to LF by petitioner of excessive and distorted amounts of its income, including New York income. Petitioner's efforts to rebut the presumption of distortion and prove that its royalty payments to LF were arm's-length through a series of analyses based on IRC § 482 principles were flawed for the reasons outlined above.

P. The Division asserts that another source of the distortion of petitioner's activity, business, income or capital within New York flows from the inability of LF to meet its obligations under its assignment and license-back agreement with LCI and its license agreement with petitioner to provide trademark maintenance services, including quality control of the marks, for the benefit of the licensees of those marks, including petitioner. The Division opines that to the extent petitioner and other licensees are providing trademark maintenance services that LF is contractually bound to provide in return for the royalties paid to it, the payment by petitioner of royalties to LF for such services that are actually provided by petitioner gives rise to

distortion. The basis of the Division's argument is that a member of a controlled group that provides nonroutine assistance in the development or enhancement of an intangible to the owner of the intangible, who is also a member of the controlled group, is entitled to arm's-length compensation for such assistance (*see*, Treas Reg 1.482-4[f][3][iii]). It cannot be seriously questioned that LHC's assets, tangible and intangible, including its knowledge of store operations, trained work force, distribution systems and its modern infrastructure provide an extraordinary level of support to LF that serves to increase the value of LF's registered marks. The failure of LF to compensate LHC for such services is distortion.

Q. The Division asserts that petitioner's license agreement with LF lacked economic substance, and that LF was formed strictly for tax avoidance purposes, a position that petitioner vigorously contests. In *Matter of Sherwin-Williams (supra)*, the Tax Appeals Tribunal discussed the two-prong test of *Frank Lyon Co. v. United States* (435 US 531, 55 L Ed 2d 550), where the court analyzed the criteria used to determine whether transactions between controlled corporations had both a valid business purpose and economic substance. The focus of the business purpose test is the subjective motive of the taxpayer for choosing to become a party to the transaction, while the economic substance inquiry is concerned with whether the substance of the transaction reflects its form, and whether there exists a reasonable possibility of profit apart from any tax benefit (*Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, 820 F2d 1543).

R. The stated business purposes of LF, as revealed in the record, include the protection and management of its registered marks toward the end of increasing their value and facilitating their future licensing, as well as to hold and manage its indebtedness and that of its affiliates. Under its various license agreements in the record with LHC or LCI, LF, as licensor, reserved

the right to establish quality control standards and, either by itself or through LHC or LCI as its authorized agent, to inspect each store and other Lowe's facility, to review licensed services and advertising materials, approve product samples and to require the production of specifications and test data relating to licensed products. While LF did issue standards of quality for licensees on August 31, 1993, and did play a subordinate role in the management of corporate debt, virtually all other activities that served to protect the registered marks and enhance their value were undertaken by LCI or LHC. Under the sham transaction doctrine, a transaction will be disregarded if it has no economic substance or business purpose other than the creation of tax benefits (*see, United Parcel Service v. Commissioner of Internal Revenue*, 254 F3d 1014, 1018). While the record includes the minutes of most of the meetings of the LF board of directors occurring both before and during the tax years at issue, there are no minutes from any meetings of the LCI board of directors that lay out LCI's business reasons for creating LF and the transfer of its valuable registered marks to LF. Neither Mr. Herring nor Mr. Niblock, who were LCI employees and board members during the tax years at issue, discussed LCI's business reasons for the formation of LF in their testimony. Mr. Green, LCI's Senior Manager of Income Taxes during the taxable years, limited his testimony to the reasons for the 1989 merger and the purposes served by the Lowe's Vision Statement.

S. While the licensing agreements empowered LCI and LHC to act as LF's authorized agents in the conduct of trademark management and protection activities, the record shows that during the tax years at issue, LF's officers, directors and its one employee lacked meaningful trademark management and quality control experience. The persons within the Lowe's organization who actually made the day-to-day decisions respecting brand management, store operations, marketing and merchandising, which were the core activities of LCI and LHC that

served to enhance the value of the registered marks, were employees of LHC or LCI, who had no formal or fiduciary ties to LF during the tax years at issue.

In *Matter of Sherwin-Williams (supra)*, the Tax Appeals Tribunal found that the functions of *Sherwin-Williams* had not changed after the assignment and license-back of the marks, despite the fact that the licensing agreements afforded the two trademark holding subsidiaries substantial decision making authority respecting such areas as advertising, quality control, third-party licensing and trademark litigation. The Tribunal also found that the lone employee and the officers of the trademark holding subsidiaries lacked any meaningful trademark experience, experience in managing branded products or experience in the paint industry. The Tribunal noted that any business arrangement which separated responsibility for trademarks and brand management from those in the company who worked with its branded products on a daily basis would expose the business to serious economic risk. This, the Tribunal determined, explained the absence of a change in the functions of *Sherwin-Williams* after the licensing agreements became effective, and supported its conclusions that the form of the *Sherwin-Williams* licensing transaction did not match its substance. LF, in its asset transfer and licensing transaction, exhibits a similar disconnect between the form of the transaction and its substance. Like *Sherwin-Williams*, after the creation of LF in 1989 and down through the tax years at issue, LHC and LCI continued to perform nearly all the duties of a trademark service provider. Before the assignment of the registered marks to LF and their license-back to LCI and LHC, LCI and LHC paid the costs of marketing Lowe's products and services, including advertising and the legal costs of protecting the existing marks and registering new marks. After the assignment and license-back of the marks and during the years at issue, LHC and LCI

continued to bear these same expenses including all advertising costs. Alston & Bird, the intellectual property attorneys for LHC, LCI and LF, dealt almost exclusively with employees of LCI, particularly Mr. Keener, and submitted their statements for services rendered to LCI. During tax year 1997, some of these statements were forwarded to LF by LCI for payment. According to its general ledger, LF paid no statements for services rendered to the intellectual property attorneys in tax year 1996, but paid them \$7,297.09 in tax year 1997. The minutes of the LF board of directors meetings reveal that the board routinely voted to accept new trademarks with minimal, if any, discussion regarding the need for the new marks. It was the LCI marketing team, rather than LF, that would develop an idea for a new brand or trade name, and then contact Alston & Bird to conduct a search to determine whether the proposed mark was noninfringing of a third party. Although Ms. Eubanks testified that her duties on behalf of LF included authorizing Alston & Bird to proceed with the application process for a new mark, she conceded that she lacked any expertise in the area of trademark management. That there is a low level of compliance by LF with the terms of the licensing agreements is not surprising, given the lack of suitable background and experience of LF's directors, officers and its one employee in the areas of trademark management and brand management that are so essential to the core activities of the Lowe's organization. An example of the corporate parent's indifference to LF's responsibilities under the license agreements and LF's standards of quality for licensees is found in the February 6, 1996 memorandum from Mr. Warden, LCI's executive vice-president and general counsel, to Mr. Niblock, LCI's then director of taxation, vice-president and treasurer. The license agreements and the standards of quality for licensees expressly prohibit a licensee from sub-licensing the marks to a third party without LF's written consent. In the memorandum,

which was copied to Mr. Elledge, an employee of LCI and a director of LF, Mr. Warden advised Mr. Niblock as follows:

You raised a good question about Lowe's Companies consenting to NASCAR's use of the Lowe's trademark and whether or not LF Corporation needs to approve or consent to such use. Although I think Lowe's probably has the right to consent to such use as part of an advertising program, it would be safer if LF Corporation would consent to the use expressly. By copy of this memo to Richard Elledge, I am requesting that he place this on the LF Corporation Board meeting agenda.

At the LF board of directors meeting held on February 12, 1996, the Board unanimously and perfunctorily consented to the use of the Lowe's trademark in accordance with the terms of the agreement between NASCAR and LCI. The memorandum of February 6, 1996 evinces a specter of indifference on the part of the parent corporation for its obligations and the prerogatives of LF under the terms of the license agreements. In *Merryman v. Commissioner of Internal Revenue* (873 F2d 879), a case which examined the economic substance of the formation of an oil drilling partnership claiming an investment tax credit, the court stated that a "low degree of adherence to the entities' contractual terms indicates lack of substance." LF's reaction to the memorandum and its willingness to "fall into line" and not question the actions of LCI demonstrates that it was not serious about protecting its prerogatives under the license agreements.

T. During the tax years at issue, money flowed between LHC, LCI and LF, but the economic positions of the entities remained essentially unchanged. During tax year 1996, LHC and LCI paid to LF, respectively, the sums of \$155 million and \$51.6 million as royalties based on a percentage of the net sales of the licensees. For tax year 1997, the royalties paid to LF by LHC was \$206 million, and by LCI the sum of \$37.7 million. During tax years 1996 and 1997, LF paid to LCI tax free dividends in the amounts of \$162.7 million and \$229 million, respectively. During these same years, LHC paid the annual management fees to LCI in the

respective sums of \$24.9 million and \$31 million. During the tax years under examination, LF borrowed money under a revolving credit arrangement with CAFCO, a member of the Citicorp Group, which loans were secured by the assignment to CAFCO of a security interest in LHC's and the other affiliate's accounts receivable. The borrowed funds were immediately transferred to LCI by LF. LCI then loaned the money to LHC for new store construction, and assigned the note evidencing each such loan to LF as a contribution to capital. For tax year 1996, LHC paid interest on these loans to LF in the amount of \$113.8 million, and for tax year 1997 it paid interest to LF in the sum of \$115.9 million. LHC claimed part of these interest payments and so much of the royalty payments as were based on New York sales as deductions on its New York State franchise tax returns for each tax year. It is LHC that required capital for new construction and LHC whose receivables made up the lion's share of the security interest held by CAFCO for the monies loaned. LF's role in this arrangement was limited to notifying CAFCO when alerted by LCI that funds for new construction were needed, and then transferring the borrowed funds to LCI. Although LF held the notes and received the interest payments from LHC as obligor, LF served as a mere conduit of the borrowed funds, acting on the instructions of LCI. LF's ministerial role in this arrangement supports the conclusion that while the underlying CAFCO funding arrangement may have economic substance, LF's limited role lacks economic substance because it serves no purpose apart from creating interest deductions for LHC on its interest payments to LF. In *Merryman v. Commissioner of Internal Revenue (supra)*, the Fifth Circuit Court of Appeals affirmed the Tax Court which held that while the operation of an oil drilling rig had economic substance, because the purpose behind the formation of the partnership was limited to the creation of tax benefits for its partners, the partnership would not be recognized for tax purposes.

In *Syms Corp. v. Commissioner of Revenue* (436 Mass 505, 765 NE2d 758), the Supreme Judicial Court of Massachusetts, in a matter factually similar to the case at bar, affirmed the determination of the Appellate Tax Board disallowing deductions of a corporate taxpayer for royalty payments it made to its wholly-owned Delaware subsidiary for the use of trade names and other intangibles, where, as here, the royalties paid were returned to the parent as a tax free dividend in what the board found was a circular transaction for the benefit of the parent. Such a circular flow of funds among related entities is an indication of a transaction lacking in economic substance (*see, Merryman v. Commissioner of Internal Revenue, supra*).

U. It is clear that when LF was incorporated in 1989, there was a need to reorganize and consolidate the Lowe's corporate structure. There were 24 separate subsidiary corporations of LCI operating stores in each state where Lowe's had a presence. Each of these corporations was using LCI's registered marks under an oral agreement, with little oversight by LCI. Mr. Keener, in his testimony, expressed concerns that he had in the 1985-1987 time frame when Lowe's was expanding into Oklahoma, Louisiana and Florida, and it was discovered that unrelated businesses using the name "Lowe's" were using LCI's registered marks under circumstances that could give rise to a claim of trade name or trademark abandonment. He discussed these concerns at the time with Mr. Herring and members of his, Mr. Keener's, law firm, Bell, Seltzer, Park & Gibson, which merged into Alston & Bird in 1995. The corporate consolidation was accomplished in January 1989, when the various separate state corporations, with two exceptions, were merged into LIC before LIC was renamed LHC. The exceptions were the Ohio and North Carolina subsidiaries, which merged into LCI. LF, which was not incorporated until July 1989, had no role in this consolidation process. Further, for public relations purposes, Mr.

Keener felt that a new corporate entity bearing a name other than Lowe's, whose responsibilities would include the enforcement of LCI's rights to its intellectual property, should be created toward the end that the Lowe's name would not be associated by the general public with litigation or other trademark enforcement activities. I reject as illogical petitioner's premise that the creation of LF as a trademark holding company is going to somehow conceal from those who are targeted for trademark enforcement activity and other members of the general public the fact that the alleged misuse of the Lowe's trade name is being challenged by an affiliate of the owner of the Lowe's network of retail stores.

V. The tax related reasons for the assignment and license-back transactions include the payment to LF of royalties and interest on loans, which take the form of tax-free income to LF and tax deductions to LCI and LHC. The funneling of LHC debt held by LCI to LF and the payment by LF of tax-free dividends back to LCI are also important tax related features of the transaction. Since LF's inception in 1989 and down through the tax years at issue, the majority of its board of directors have been LCI employees, board members and officers with backgrounds in finance and taxation as opposed to trademark management, store operations, retailing or marketing. This accounts for the LF board's emphasis at its meetings on investments and state tax issues, with much less focus on trademarks and the core operations of petitioner's stores. The relative importance to LCI of the tax related reasons, compared to the business related reasons, for the transactions in question is revealed by its inaction following Mr. Keener's advice to management of possible trademark abandonment claims in the 1985-1987 time frame and its far more urgent response to the January 1989 AA State Tax Review, which formed the foundation of the trademark transfer and license-back transactions that soon followed. On June 9, 1989 the LCI Board by resolution approved the formation of LF, which

was incorporated in Delaware on July 6, 1989. The AA State Tax Review was commissioned by LCI's tax department to identify state tax minimization opportunities. The merger plan ultimately adopted by LCI, whereby 24 of LCI's subsidiaries would merge into LCI or LIC, was formulated and strongly recommended by AA for no reasons other than tax savings.² It is obvious that the royalty payments made by LHC and LCI to LF were not paid in return for services provided by LF because LF provided few services to its licensees. LHC and LCI, to the exclusion of LF, shared the costs of advertising and otherwise marketing the trademarked products and services to the public. There was no proof that LF paid any of the legal fees of the intellectual property attorneys in tax year 1996, although it did make such payments in tax year 1997. All of the trademark registration and protection services performed by Alston & Bird were rendered directly to LCI.

LF did reimburse LCI for a modest part of the cost of the store inspections conducted by LCI's Internal Audit Department. Of the 89 full store audits conducted in tax year 1996, each of which required two employees two weeks to complete, LF's share of the cost of these 89 audits was limited to 10 man hours per audit. Of the 344 mini-audits completed in the same tax year, each of which required one employee 1.5 days to complete, LF's share of the cost of each such audit was one man hour.

LF's contribution to the debt management function was to borrow funds under the CAFCO arrangement when told to do so by LCI, immediately wire the funds to LCI and then to receive the tax deductible interest payments from LHC for payment by it to CAFCO. It has not been established why the LF functions relating to the management of the LF investment portfolio could not have been performed by the majority of the LF board in their capacities as LCI or LHC

²While the merger plan adopted did have nontax business advantages, the AA State Tax Review recited only tax advantages and LCI showed no interest in any merger plan until presented with tax advantages.

employees, officers or board members managing an LCI or LHC investment portfolio. LCI at the time was providing executive and corporate management services to LHC, but not to LF. Even if petitioner had met its burden to prove that the royalty rate paid to LF by petitioner was arm's-length, I find that the Division has carried its burden to prove that the transfer and license-back transactions had no business purpose apart from tax avoidance, lacked economic substance other than the creation of tax benefits, and that the royalty payments made to LF were a contrived mechanism to limit petitioner's exposure to state franchise taxes (*Syms Corp. v. Commissioner of Internal Revenue, supra*).

W. Petitioner asserts that the Division is not authorized to require LHC to file a combined report with LF because LF has also received royalty and other income from LCI during the tax years at issue. Petitioner contends that because the Division did not issue a notice of deficiency to LCI, and because LCI is not a party to this proceeding, the forced combination of LF and LHC would not properly reflect LHC's New York State franchise tax liability. Tax Law § 210 (8) reads, in part, as follows:

If it shall appear to the [commissioner] that any business or investment allocation percentage or alternative business allocation percentage determined as hereinabove provided does not properly reflect the activity, business, income or capital of a taxpayer within the state, the [commissioner] shall be authorized in [his] discretion, in the case of a business allocation percentage, to adjust it by (a) excluding one or more of the factors therein, (b) including one or more other factors, such as expenses, purchases, . . . (c) excluding one or more assets in computing such allocation percentage, provided the income therefrom is also excluded in determining entire net income or minimum taxable income, or (d) *any other similar or different method calculated to effect a fair and proper allocation of the income and capital reasonably attributable to the state . . .* (emphasis provided).

Petitioner's point regarding the inclusion in LF's ENI of the royalties received from LCI adversely affecting the proper reflection of LHC's New York State franchise tax liability is well taken. However, the reasons for its concern may be ameliorated through the application of

section 210(8)(d) of the Tax Law which authorizes the commissioner, in his discretion, to exclude from LF's ENI the amounts of royalty income, as reported in the Lowe's consolidated Forms 1120, received by LF from LCI during each of the tax years at issue.

X. Inasmuch as the presumption of distortion remains intact and the transfer and license back transactions are determined to lack a valid business purpose and economic substance, the petition of Lowe's Home Centers, Inc. is denied and the Notice of Deficiency, dated December 26, 2000, is sustained.

DATED: Troy, New York
September 30, 2004

/s/ Gary R. Palmer
ADMINISTRATIVE LAW JUDGE